
Audit of Na Wai Ola Waters of Life Charter School

A Report to the
Governor
and the
Legislature of
the State of
Hawaii

Report No. 05-01
January 2005



THE AUDITOR
STATE OF HAWAII

The Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.
2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
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6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds are existing funds meet legislative criteria.
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8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.
9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.



THE AUDITOR STATE OF HAWAII

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OVERVIEW

Audit of Na Wai Ola Waters of Life Charter School

Report No. 05-01, January 2005

Summary

Na Wai Ola Waters of Life Charter School was established in 2000. Located near Kurtistown on the Big Island, the school provides regular and special education to over 130 children in kindergarten through grade 12 from the Puna and Hilo areas.

We found that defects in the charter school law and a lack of pro-active oversight by the Board of Education have contributed to the school's history of financial crises. In addition, Waters of Life Charter School's governance and business practices have been poorly planned and managed, leaving its financial viability in question.

The charter school law lacks clear authority and responsibility assignments, resulting in conflicting roles and uncertainty. It also provides little basis for ensuring accountability and school viability, and does not address issues that may expose the State to unintended liabilities and entanglements. Such issues include the ownership of real estate purchased by charter schools, liability for debt for mortgages or major facility improvements, and the risks associated with business ventures undertaken by charter schools to supplement their income. These issues have arisen with respect to Waters of Life Charter School.

The Board of Education awarded a charter to Waters of Life Charter School based on an inadequate business plan and before the school was ready to manage its finances in an effective and responsible manner. These deficiencies are contributing factors in the school's subsequent management failures and financial problems. In addition, the board has not held the school accountable and has no reliable measures of the school's success in providing children with an education. We also found that the board's oversight does not extend to ensuring that teachers have the qualifications the school committed to in its contract with the board, and to documented compliance with student safety and health requirements.

Waters of Life Charter School's defective planning and governance have contributed to financial problems. Its board lacks the diverse and experienced membership needed to oversee the administration of an operation with an annual budget nearing \$1 million. The school's inadequate fiscal management has caused waste and losses and leaves its leaders without reliable financial information for decision-making. Expenditures, \$2.6 million since the school's inception, lack justification and documentation. Uncertainty about its ability to meet large financial commitments, including a \$380,000 mortgage, cloud Waters of Life Charter School's future viability.



Recommendations and Response

We recommend that the Legislature enable the Board of Education to establish a committee or panel that will recommend revisions to improve the effectiveness of the charter school law.

We also recommend that the Board of Education establish clear strategies for the oversight of charter schools, clarify its expectations in agreements with charter schools, and adequately evaluate business and financial plans in any future charter applications. Additionally, the board and the Charter School Administrative Office should foster the exchange of proven solutions to common problems among all Hawaii charter schools.

Finally, we recommend that Waters of Life Charter School adopt written policies and procedures for accounting, procurement, and personnel practices and acquire the expertise needed to improve its governance and business operations. The school should also take the necessary steps to comply with statutory and contractual reporting requirements, including an independent financial audit.

Na Wai Ola Waters of Life Charter School, the Board of Education, the Department of Education, and the Charter School Administrative Office responded to a draft of the report. While generally agreeing with our conclusions, the responses included several disagreements and suggested clarifications. We made some minor changes to improve clarity and accuracy based on their suggestions.

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Hawaii

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 05-01
January 2005

Foreword

For this report, we audited the Na Wai Ola Waters of Life Charter School and issues relating to the charter school law and the Board of Education's oversight role that impacted the school.

The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

We wish to express our appreciation for the cooperation and assistance extended to us by Na Wai Ola Waters of Life Charter School and others whom we contacted during the course of the audit.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

Na Wai Ola Waters of Life Charter School (Waters of Life Charter School) is the first of Hawaii's charter schools to be audited by the State Auditor. It was chosen in part because of concerns raised about its management, especially its fiscal administration and legal challenges on zoning issues.

The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes (HRS), which requires the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

Background

Hawaii's charter schools are authorized by Chapter 302A, Part IV, Section D, HRS, entitled New Century Charter Schools. These schools are publicly funded and are operated either by a local school board formed by community groups or private organizations, or by a board comprised of parents, educators, and community members. Charter schools are held accountable through written contracts between the local school boards and the state Board of Education.

Generally, charter schools are given wide-ranging freedom from statutory and regulatory requirements. In return, they are held accountable for student and operating performance and other requirements specified in their contracts with the State, known as a charter. A charter can be revoked if a school fails to meet its statutory requirements; a revocation would most likely cause the school's closure.

The Hawaii Legislature created charter schools with the stated intent to increase autonomous and flexible decision-making at the school level. It expected that freedom from bureaucratic red tape and accommodation of individual students' needs would dramatically raise the State's educational standards. To advance this goal, the charter school law provides that these schools are exempt from "all applicable state laws," except for laws regarding collective bargaining, discriminatory practices in employment, and health and safety requirements.

In addition to broad administrative flexibility, charter schools also enjoy substantial spending flexibility. While specifically exempt from the Hawaii Public Procurement Code, these schools must develop policies and procedures consistent with the goals of public accountability and procurement practices.

In Hawaii, there are two kinds of charter schools: new century charter schools and new century conversion charter schools. New century charter schools are newly created schools that may secure their own facilities or use facilities of existing public schools, so-called “schools-within-schools.” New century conversion charter schools are public schools whose management and operations were transferred from the Department of Education to a local school board.

State law permits the creation of 23 new century charter schools and 25 new century conversion charter schools. As of September 2004, 23 new century charter schools and four conversion charter schools were operating, totaling 27 schools. Twelve charter schools are located on the island of Hawaii, ten on Oahu, three on Kauai, and two on Maui. With some exceptions, these schools tend to be smaller than comparable department-run schools. Charter school enrollment totaled 4,502 students statewide during school year 2003-04. Students were accommodated in schools ranging from 27 to 604 students. Eleven of the 27 charter schools have an enrollment of less than 100 students.

Charter School Administrative Office

Act 203, Session Laws of Hawaii (SLH) 2003, created the Charter School Administrative Office, which is administratively attached to the department and headed by an executive director. The executive director, under joint direction of the Board of Education and the charter schools, is responsible for the internal organization, operation, and management of charter schools. Specific responsibilities include preparing and executing the overall budget for charter schools; allocating funds; complying with applicable state laws related to charter school administration; facilitating financial audits; and preparing and executing contracts for centralized services. In addition, the executive director represents charter schools in communications with the board, the governor, and the Legislature, and is charged with monitoring and supporting the development, growth, and progress of charter schools.

The Charter School Administrative Office also assumed some functions previously performed by the department and the Board of Education, including monitoring and maintaining charter school annual self-evaluations and supporting the local school boards, respectively. Such support includes assisting with formulating detailed implementation plans and serving as a member of the new century charter school review panel.

Board of Education

The Board of Education approves each charter school’s detailed implementation plan based on a charter school review panel’s recommendation. The law states that the review panel must include four board members, the Charter School Administrative Office executive

director, and two members of the charter school community. Each school's plan must address employee rights; student recruitment; curriculum; governance structure; facilities; and assessments for students, teachers, and administrative support. After the Board of Education approves the detailed implementation plan, the plan becomes a written performance contract between the board and the charter school.

In addition to ensuring compliance with the terms of the charter, the Board of Education has the statutory responsibility to assure the school's organizational viability, compliance with applicable state laws, content and performance standards, and fiscal accountability.

To this end, the charter school law requires the Board of Education to initiate an independent evaluation of each charter school during its first two years of operation and every four years thereafter. If a charter school is found to fail in its student performance standards or is not fiscally responsible, the Board of Education must place the school on probation for one year. If the school's status does not improve during the probationary period, its charter may be revoked by a two-thirds majority vote of the Board of Education.

Department of Education

The Department of Education created the Public Charter Schools Program under the Public Affairs Office in 2000 to facilitate the creation of new public charter schools and to support existing charter schools. The Charter School Administrative Office has assumed the allocations of general funds and resolving operational issues between the charter schools and the department and the Board of Education.

The department has funded charter schools from its general fund appropriations and federal impact aid moneys. Until FY2002-03, state funding was determined by the Office of the Auditor based on the charter school law. For FY2003-04, the Legislature set funding at \$5,355 per student. Beginning in FY2004-05, the Charter School Administrative Office will assume budgetary and allocation functions over state general funds for charter schools. The department will continue to administer the distribution of federal funds to all schools, including charter schools.

The department is also required to collaborate with the Charter School Administrative Office to provide technical assistance on compliance with state and federal laws and access to state and federal grants. In addition, the department makes centralized services, such as food services and payroll processing, available for purchase by charter schools, and provides special education services when the charter school is unable to provide all required services.

Waters of Life Charter School

The Waters of Life Charter School received its charter in July 2000 and began operating the next month. The school provides kindergarten through 12th grade (K – 12) education and special education programs. Electronic and correspondence curricula also allow high school students to pursue their diplomas independent of the traditional classroom setting.

The school primarily serves the Big Island's Puna district, but also draws students from the Hilo area. The charter school has changed locations several times and is currently holding classes at several sites in the vicinity of Kurtistown, including the Ainaloa Community Center and the Girl Scout Center. Its administrative offices are located on the school's 28-acre farm property. The school's by-laws provide for its administration by an 11-person local school board and a director.

Waters of Life Charter School's revenues include general fund allocations, federal grants, gifts, and donations. Exhibit 1.1 displays the school's annual general fund and federal impact aid allocations.

Exhibit 1.1 Annual State and Federal Impact Aid Allocations to Waters of Life Charter School, FY2000-01 through FY2003-04

Fiscal Year	Number of Students	Total Allocation
2000-01*	172	\$766,841
2001-02*	76	\$235,224
2002-03*	156	\$490,845
2003-04	131	\$692,133

*Includes an allocation of federal impact aid from the Department of Education

Source: The Department of Education

Public funds received by Waters of Life Charter School between FY2000-01 and FY2003-04 totaled over \$2.6 million. In 2002, the Board of Education established a five-year repayment plan for a deficit of over \$250,000 incurred in the school's first two years of operation. The board also placed the school on probationary status for that duration.

Objectives of the Audit

1. Determine whether Waters of Life Charter School is in compliance with applicable laws and regulations and its charter.
2. Assess Waters of Life Charter School's management controls, including financial, personnel, and procurement practices.
3. Make recommendations as appropriate.

Scope and Methodology

The audit focused on the management practices and controls of the Waters of Life Charter School as well as the school's compliance with state and federal laws, rules, and regulations from FY2002-03 to the present. We examined processes and transactions dating to the school's inception in FY2000-01 as needed in order to provide perspective for interpreting more recent events. Where necessary and relevant to the audit objectives, we evaluated the Board of Education and Charter School Administrative Office executive director's statutory responsibilities as they pertained to the Waters of Life Charter School. Site visits to the school's Big Island facilities were included in our fieldwork.

During our audit, we identified issues regarding the charter school law, Chapter 302A, part IV, Section D, HRS, and the role of the Board of Education as a charter school authorizing agency.

Audit procedures included interviews with the Waters of Life Charter School's current and former local school board members, teachers, and staff; an examination of the school's detailed implementation plan, policies and procedures, reports, accounting transactions, and other relevant documents to assess the effectiveness of the school's performance in accordance with pertinent laws; and a review of management controls in the areas of financial management, personnel, and procurement. We conducted site visits and observations, including classes in session at the school's campuses. We also interviewed pertinent individuals and examined relevant documents at other agencies, including the Department of Education, the Board of Education, and the Charter School Administrative Office.

Our audit work was conducted from June 2004 through November 2004 according to generally accepted government auditing standards.

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Chapter 2

Statutory, Oversight, and Management Deficiencies Cloud the School's Future

A poorly crafted charter school law, the Board of Education's passive oversight over charter schools, and Waters of Life Charter School's mismanagement of its affairs have contributed to placing the school's viability in question. Sweeping steps must be taken to improve the school's governance and financial management to ensure its future, recognizing that only a financial audit, which is overdue, can provide detailed insight into the school's finances.

In the course of our audit of the Waters of Life Charter School's management, we identified issues outside the school's control that impact its operations and management practices. These issues—a flawed charter school law and the Board of Education's oversight practices—affect whether charter schools are held accountable for their stewardship of public funds. Accordingly, a discussion of these points and their impacts is included in our report. However, the school's fate still rests in the hands of its managers. Establishing a stable, viable school will be a daunting task despite anecdotal reports that the school is a good fit for some students.

Summary of Findings

1. Hawaii's faulty charter school law impedes accountability and effective support.
2. The Board of Education lacks a proactive strategy for overseeing the Waters of Life Charter School.
3. The Waters of Life Charter School's disregard for sound governance and business practices has placed its continued viability at risk.

Hawaii's Faulty Charter School Law Impedes Accountability and Effective Support

We found that the Hawaii charter school law, with its confusing provisions and poorly defined powers and responsibilities, is open to conflicting interpretations and hinders the effective oversight of charter schools. Vague provisions in the law have contributed to insufficient oversight over charter schools by the Board of Education, exclusion of some school employees from state benefits, and avoidance by at least one charter school, Waters of Life Charter School, of the level of accountability envisioned by the charter school law.

Lack of clarity blurs the balance between charter schools' independence and stewardship of public funds

The charter school law (Chapter 302A, Part IV, Section D, HRS—New Century Charter Schools) exempts charter schools from all applicable state laws, except those relating to collective bargaining, discriminatory employment practices, and health and safety requirements. This provision, specifically Section 302A-1184, HRS, has created confusion because of its broad, sweeping language.

The attorney general initially advised the Board of Education that the exemption freed charter schools from complying with *all* state laws except for those relating to collective bargaining, discriminatory employment practices, and health and safety requirements. More recently, however, the attorney general opined¹ that the exception applies only to those state laws relating to public schools, arguing that to broadly exempt charter schools from all state laws would mean that charter schools would not be subject to the state's tax, labor, worker's compensation, and criminal laws. The attorney general does not believe such sweeping results were intended by the Legislature.

In contrast, the Office of Information Practices concluded that charter schools are indeed exempt from *all* applicable state laws, including sunshine laws. Agreeing with that position, the County of Hawaii stated that it would not require charter schools to obtain a special permit required under state law to locate schools in state land use agricultural districts. Relying on that opinion, the Waters of Life Charter School purchased a farm property for its school facilities but then found itself faced with the unexpected cost of complying with a state law from which it believed itself exempt. The confusion surrounding the law suggests a need for clarification.

According to the director of the U.S. Department of Education's charter school program, similar statutory exemptions in most other states are limited to laws applicable to schools, adding that a broader exception may not be in the public interest. Furthermore, a model charter school law proposed by the Charter Friends National Network, which is based on the experience of early charter school states, suggests an exemption from laws and rules be limited to those applicable to school boards of school districts. A bill intended to address some of these issues passed Hawaii's Legislature in 2004 but was vetoed by the governor. In her veto message, the governor expressed concern that the bill compounded the inherent confusion and unfairness charter schools endure and called for a comprehensive and coordinated overhaul of the charter school law.

Ill-defined powers and responsibilities provide unsound accountability framework and allow management problems to fester

The powers and responsibilities of the Board of Education, local school boards, and the Charter School Administrative Office are not clearly defined in the charter school law. Uncertainty over the meaning of statutory provisions and limits on sanctions have allowed the Waters of Life Charter School to avoid accountability and the consequences of failing to address ongoing management problems. A more effective charter school accountability framework is needed to provide clear guidance on the parties' responsibilities and appropriate, enforceable consequences for non-compliance.

A number of charter schools in the state have failed to submit audit reports and self-evaluation reports as required by law. A vague provision requiring the Board of Education to initiate an independent evaluation of each charter school is silent on whether the board may oblige a school to cooperate and pay for the service. The Waters of Life Charter School, for example, is obliged under its charter to conduct the independent evaluation. Although required for each of the first two years of existence and every four years thereafter, no such evaluations have been completed for any of Hawaii's charter schools, according to the board. However, the board is currently in the process of initiating the first of such evaluations, four years after approving the first charters to schools subject to the requirement.

There is some uncertainty as to whether the Board of Education can compel the schools to meet their statutory and contractual obligations. The board believes that it has no authority to compel compliance, and hence takes a passive approach to charter school oversight. Section 302A-1186(b), HRS, limits the board's powers to placing a charter school on probation in cases where student performance standards are not met or a school is not fiscally responsible. Only if the school fails to meet the requirements of probation can the charter be revoked. In the case of the Waters of Life Charter School, these disciplinary actions do not appear to have helped the school address management problems.

In fact, the board believes that Hawaii law gives it no authority to intervene in school management, for example requiring a school to budget for consultant assistance or adequate business staff, or even temporarily assuming mismanaged functions to preempt a school's failure. Organizations such as the National Association of Charter School Authorizers² promote the inclusion of intervention as one of the major ongoing oversight functions for authorizers.

For example, California's Fiscal Crisis and Management Assistance Team, created to help California schools meet their financial and management responsibilities with consulting and intervention services, may provide a model for an intervention and support function to assist schools in need of better management. This agency was created in

response to legislative concerns about financial “meltdowns” requiring state bailouts and is empowered by law to investigate suspected fraud and misappropriations. Even with a small 14-person staff, this agency has provided effective and money-saving management solutions for California’s 1,000-plus school districts, including charter schools.

Limits on an authorizer’s authority to impose disciplinary or corrective action on noncompliant schools inhibit the authorizer’s ability to address problems or violations. An Arizona auditor general report³, for example, concluded that the Arizona State Board of Charter Schools’ courses for disciplinary and non-disciplinary action should include an array of options to allow more customized approaches, including letters of concern to put schools on notice of possible future disciplinary action, mandatory training, or increased withholding of state funds where progressive disciplinary action is warranted. The report further stressed the importance of the board adopting appropriate administrative rules and supportive guidelines to govern the administration of disciplinary actions. Failure to do so can subject any board action to questions of appropriateness and validity.

Hawaii law currently envisions that the newly created Charter School Administrative Office will assist charter schools with some of these issues, but that office, too, faces challenges. For instance, the office’s executive director must answer to both the Board of Education and the charter schools. The office also plays a dual role of being both a supervisor and supporter to charter schools. While the office’s executive director is responsible for the internal organization, operation, and management of charter schools—all of which are functions consistent with an oversight role—the director is also required to submit budget requests, allocate funding, manage services contracts, and represent charter schools to the Board of Education, governor, and Legislature. In addition, the director must monitor and support charter schools’ development, growth, and progress. The law is silent on the director’s responsibility and authority to intervene, for example, if financial or management problems are found that threaten the survival of a school. Ultimately, the role of the Charter School Administrative Office is ambiguous.

***Unresolved issues
create uncertainty and
potential liabilities for
the State***

The charter school law’s vagueness has created uncertainty about charter schools’ degree of independence from state government. The law also leaves some important issues unresolved.

In some states, charter schools are considered legally independent entities. Hawaii’s charter schools, on the other hand, have recently been determined by the attorney general to be state agencies under current law. Greater independence means greater autonomy but less ability to

benefit from state-provided services and protection. For example, Hawaii charter schools are covered for property and liability insurance by the State, a service schools in other states must procure from the private sector. Conversely, a closer link to government tends to incur administrative requirements and limitations that may not be desirable to an entity seeking freedom from bureaucratic burdens.

The Hawaii charter school law's vagueness on the status of charter schools as government agencies has, for example, resulted in inconsistencies in employee benefits availability and raised questions about potential liabilities and entanglements for the State. Moreover, legislative intent on financing charter school facilities has not been addressed.

Employee benefits entitlements and assessments remain unresolved

Important employment benefits issues were not considered or resolved when the charter schools were created. It was not until November 2003 that the attorney general clarified⁴ that charter schools are agencies of the State and their employees are state employees. Consequently, charter school employees are entitled to benefits available to other state employees. We found, however, that actual practices deviate. Only those charter school employees whose pay is processed through the Department of Education's payroll system currently receive all state benefits.

The department processes the salaries and benefits of primarily the certificated teachers at charter schools. Other charter school employees are paid through the schools' own payroll process and receive the benefits provided by the school, such as health insurance procured from private sector carriers. According to the Charter School Administrative Office, school-paid employees include most principals (at least 20 principals are on the charter schools' payroll), uncertificated teachers, and administrative, custodial, transportation, and other support staff. While charter schools have considerable flexibility in setting pay rates and employment standards, all of their employees are entitled to the benefits available to all state employees.

In addition, charter schools are assessed the cost of these benefits and payroll taxes as a fixed amount per student. Such assessments against student numbers instead of against the size of the payroll result in excessive charges for schools with few staff—in extreme cases, these charges have approached or even exceeded a school's entire payroll. Generally, state agencies are assessed benefits and payroll tax costs as a percentage rate, currently about 24 percent of payroll.

The State may become liable for mortgages on real property

Section 302A-1186(d), HRS, gives the State the first right to all assets and facilities if a charter school fails. The law is silent as to whether the State bears responsibility for unmet obligations if a charter school has to be closed.

For example, the Waters of Life Charter School has purchased real property and used debt financing to be financed in part by the state funding it expects to receive. Its mortgage is substantial—\$380,000—and raises a possible liability risk to the State should a default occur.

Similar issues would arise should schools sign long-term facility leases or obtain loans for facility improvements. Colorado law addresses these concerns by protecting the public purse: leases and financial obligations do not revert to a school's authorizing agency unless the agency specifically assumes those obligations. The law thereby provides the authorizing agency with a means to manage and mitigate obligations impacting public funds.

For-profit ventures may raise revenues but also create unintended legal entanglements

When the Waters of Life Charter School purchased its farm property, the purchase included a business that markets and sells plants and is expected to contribute to the school's revenues. Engaging in for-profit ventures raises a number of potential entanglements which may have unexpected outcomes for the State. First, protection of the State's interest in school assets may be in question if business assets' ownership is placed in the hands of an individual or corporation. Second, allowing the use of public funds, such as federal grants, to support a for-profit venture may be attributed to a failure on the State's part to properly oversee the school. Finally, school and business operations can become entwined if the business operates in the school's state-funded facilities and uses school-paid utilities, all without reimbursement.

Facilities funding issues have not been resolved

The Legislature's intent on whether or how charter school facilities should be funded has never been addressed. While charter school funding is based on the Department of Education's per student operating cost, some charter schools cover the expense of renting or purchasing facilities with operating moneys. The department's own facility acquisition costs are separately appropriated through capital investment projects funding, primarily paid by long-term bonds.

Conversion charter schools have retained their original Department of Education campuses. Some of the start-up charter schools use department-provided buildings as schools-within-schools while others have secured facilities on their own. Some of these are located in commercial buildings or community centers, and have required modifications. Lease payments for such facilities can be significant. In other jurisdictions, supplemental funding may be made available for facilities costs or the charter school law may give charter schools preferential eligibility for available state-owned buildings. However resolved, Hawaii's charter school facilities issue is ripe for discussion.

The Board of Education Lacks a Proactive Strategy for Overseeing the Waters of Life Charter School

The Board of Education uses Hawaii's vaguely worded charter school law to justify its passive oversight over charter schools. It has not developed adequate policies and guidelines, thus missing an opportunity to provide the leadership needed to facilitate viable charter schools and ensure they meet their obligations.

In the case of the Waters of Life Charter School, the board approved its charter notwithstanding an unsound business plan. At present, the Board of Education cannot attest to the Waters of Life Charter School's organizational viability nor provision of the education specified in the charter contract because the board has not held the school accountable.

Board members mentioned that the board was unprepared to authorize and oversee 23 start-up charter schools beginning in Spring 2000. However, assignment of these responsibilities cannot have been a surprise, given that the legislative efforts to authorize start-up charter schools began as early as 1997 and concluded with Act 62, SLH 1999, which took effect in May 1999.

Waters of Life's fiscal problems are rooted in the board's approval of a defective detailed implementation plan

We found that Waters of Life Charter School was not prepared to start school operations after receiving its charter in July 2000. The school's founders lacked the expertise to design a business plan and set up adequate management systems, policies, and procedures. The school's detailed implementation plan, which the board approved and which became its charter contract, illustrates its leader's lack of business knowledge. The board's review of the plan was focused on educational issues and ignored basic elements of a viable business plan for the proposed school.

We identified a number of problem areas that should have been addressed before the school was allowed to accept students. First, the two-year financial projections lacked evidence that the founders had a realistic financial plan. The budget was designed for an operation of 495

students when the school expected only about 200 to enroll. The actual student count was only 176. No funding was included for a financial audit and an independent evaluation, although these were required by law and specifically included in the detailed implementation plan. Unrealistically low amounts were budgeted for support staff.

Second, facilities had not been secured when the charter was awarded and the plan was vague about how the Waters of Life school would acquire and have ready a safe and adequate facility by the beginning of the school year. The board's own evaluators who reviewed the plan voiced strong concern about this issue and recommended against approving the plan. The board nevertheless approved the charter.

Third, personnel and financial management policies and procedures are essential for a well-planned start-up entity, yet the school's detailed implementation plan omitted these. The school's plan reflects a lack of understanding of the statutory requirement for school procurement policies and procedures. The plan instead described an in-house, on-line store intended to elicit rebates from suppliers. The on-line store never materialized. Waters of Life Charter School is still without written policies and procedures governing procurement, personnel, and financial management.

The board's review of the school's governance plans did not adequately scrutinize the school board's membership and how it was to be governed. Waters of Life Charter School's detailed implementation plan responded only to the fairly general criteria specified by the charter school law, which at the time required the inclusion of members representing principals, teachers, support staff, parents, students, and the community. The plan did not address how the school would involve professional business expertise recommended for business start-ups including charter schools.

Best practices suggest that diverse skills are needed to compose a school board that can offer meaningful guidance to a new charter school. Other states have issued detailed best practices guide on charter school governance, including the *Massachusetts Charter School Trustees Guide*⁵ and the *Illinois Charter School Developer's Handbook*⁶. These guides list skills in fundraising, finance, facilities, governance, human resources, and public relations as essential for a board. Small business experts assert that a lack of professional advice often and early is likely to invite problems, suggesting that the availability of an attorney, an accounting professional such as a certified public accountant, and consultants with expertise in business and school development is essential before and during the start-up period.

Waters of Life Charter School leaders contend that insufficient funds prevented the school from obtaining professional advice. Yet other

Hawaii charter schools with the same level of state funding included funds in their budget for professional services. Waters of Life Charter School chose not to dedicate resources to support the business end of its operation.

The board has not developed a process to ensure the school is meeting its charter

The Board of Education has not developed adequate policies and procedures to carry out its charter school authorizer function. Without a framework in place, the board lacks the means to ensure that charter schools live up to their commitments and comply with the law. Specifically, the board has not held Waters of Life Charter School accountable for its stewardship of public funds, has unreliable measures of the school's educational achievements, and has allowed it to breach its charter and risk student safety. In addition, while the board has involved the Department of Education in charter school oversight, it has not defined the department's role.

The principles and standards developed by the National Charter Association of Charter School Authorizers⁷ for responsible charter school oversight include the following among the most important requirements: adopting clear, consistent, and transparent processes for policy and procedures development; implementing policies and procedures that streamline oversight; and defining external relationships and lines of authority. These standards also advocate for systems ensuring that all information needed to evaluate school performance is collected and consequences of non-compliance articulated.

The Board of Education indicated that the charter school law prevents a more effective oversight role because it is unable to attach meaningful consequences to accountability breaches. However, the board is the policymaking body as provided under the State Constitution for the State's education system and is specifically empowered by Section 302A-1101, HRS, to adopt student performance standards and assessment models and monitor school success, which by extension includes charter school success. Therefore, there should be no impediment to the board's ability to establish processes to fulfill its charter school authorizer function. Board members acknowledged that the board has been slow to familiarize itself with its charter school authorizer function, indicating the board has pursued its oversight responsibilities with limited enthusiasm.

The board has not held the school accountable

Since its charter was issued in 2000, Waters of Life Charter School has not submitted annual financial audits and self-evaluation reports. This violates charter school law and the charter contract between the school and the board. Repeated requests by the board have gone unanswered.

As a result, the board currently lacks the requisite information to validly assess the school's viability, financial accountability and the quality of education received by its students.

Board of Education minutes indicate that this problem is not confined to the Waters of Life Charter School. For example, in October 2003, 13 of 26 charter schools then chartered had not submitted the accountability reports required by law. The board contends that according to its legal counsel, the law limits its remedies for noncompliance. Nonetheless, the charter school law allows the board to adopt guidelines to supplement accountability measures. Such guidelines, however, remain non-existent.

Existing measures provide no answers about the school's quality of education

School year 2002-03 reports on No Child Left Behind testing by the Department of Education rate the Waters of Life Charter School as having made adequate yearly progress and being in good standing. However, we found that the school's progress cannot be determined from the available information. The school's small population does not allow valid conclusions on its achievements in tests administered under this program.

The federal No Child Left Behind Act of 2001 requires state education agencies to show that students of every school, including charter schools, have made "adequate yearly progress" towards reaching the goal of 100 percent proficiency by 2014. Adequate yearly progress is measured by meeting increasingly challenging proficiency levels. For example, for school years 2001-02 and 2003-04, a school must achieve a 30 percent proficiency level in reading and 10 percent in mathematics. These targets increase to 44 and 28 percent, respectively, for school year 2004-05.

The Department of Education's assessment consists of ten test sessions (nine for grade 3), each with at least 30 questions, administered over a ten-day period of the school's choice during the months of March and April to grades 3, 5, 8, and 10. Two sessions, measuring achievement in reading comprehension and mathematics problem solving, are based on the Stanford Achievement Test, 9th edition (SAT9), while eight sessions (seven for grade 3) measure achievement towards meeting Hawaii Content and Performance Standards for reading, writing, and mathematics. The SAT9 test, called a bell-curve or norm-referenced test, measures a student's performance compared to a national average. The Hawaii Content and Performance Standards test, on the other hand, is a locally-developed and scaled test of ten content areas. It is designed to hold the school accountable for teaching students what they should know, be able to do, and care about in identified content areas.

According to the department, this test is more challenging than a norm-referenced test and more relevant to what parents need to know about their children's learning.

Waters of Life Charter School has tested children in grades three, five, eight, and ten, and received school-wide proficiency scores of 31 percent in reading and 15 percent in mathematics for school year 2002-03, apparently meeting the benchmarks of 30 and 10, respectively. These scores may be misleading, however, as we found that the school tested as few as four children in each class and less than 30 in the entire school. For example, the school tested four grade 10 students in English language in 2003. Official enrollment for this grade was at least 15 students. In 2002, the school tested five grade 10 students when its stated student count was 12. The school explained that students repeating a lower grade and others who had transferred distorted the enrollment numbers. We could not verify the enrollment discrepancy but found that at least two students enrolled during the testing period were not tested.

With so few students tested, the exclusion or abnormal performance of one or two students can have a significant impact on the overall score. For example, if either the most or least successful students in a small class were not tested, the class average will be significantly different. A hypothetical range of test scores illustrates this point:

5 students enrolled				64 students enrolled			
# of students	% Score	% Score	% Score	# of students	% Score	% Score	% Score
1	50	50	excluded	1	50	50	excluded
1	40	40	excluded	1	40	40	excluded
1	30	30	30	60	30	30	30
1	20	excluded	25	1	20	excluded	20
1	10	excluded	10	1	10	excluded	10
Average	30	40	22	Average	30	30	30

In the example, if a test of five students who on average met a 30 percent proficiency level excluded the two highest scoring students, the class average would plummet to a failing 22 percent; excluding the lowest scoring students would raise the average to a comfortable 40 percent. With 64 students, however, excluding two identical high or low scores would not affect the overall average score.

The Department of Education uses a composite score, not an average. However, its accountability guidelines acknowledge that 30 is the minimum number of students required for calculations to validly reflect a group outcome. While this can mean that small schools, such as Waters

of Life Charter School, may not be subject to corrective measures should they fail to meet minimum proficiency levels under the No Child Left Behind program, it also means that the Board of Education lacks an objective measure that would attest to the school's educational achievement.

We were unable to review the testing process, and therefore have no information on Waters of Life Charter School's administration of tests. Further, our review of the school's, the Board of Education's, and the Department of Education's records of the school's testing administration revealed no incidence or suggestion of testing irregularities. Yet, because of the importance assigned to these test results, coupled with the opportunity for schools to manipulate the test and few controls over the testing process, the integrity of the process may be at risk.

The Department of Education has delegated test administration to each of the charter schools. Test materials are provided in advance to the school with no requirement for independent oversight that would, for example, preclude a class teacher from aiding his or her pupils before or during tests. The department's major safeguard is a scan for obvious irregularities. Opportunity exists for teachers to assist students inappropriately. Extensive cheating on high-stakes tests by teachers has been found on the mainland: a 2002 Chicago public schools study⁸ concluded that cheating occurs in 3 to 5 percent of elementary school classes annually, and the test results for 29 of 120 classes subject to the study warranted an investigation. There have also been at least two cases of inappropriate assistance reported to the Department of Education on tests at Hawaii public schools.

Teacher qualifications fail to meet charter requirements

The Board of Education has not ensured that the Waters of Life Charter School complies with its charter's teacher qualification requirements. In addition, our review of documented qualifications and interviews with school managers raise questions about the school's ability to meet the qualification standards required under the federal No Child Left Behind Act.

In its written performance contract, the school committed to high teacher qualification standards. The charter provides three alternative ways for teachers to meet requirements: 1) a State of Hawaii teacher's license; 2) evidence of a bachelor's degree, a teacher preparation program, and student teaching; or 3) evidence of a degree in the chosen subject and at least two years of teaching experience.

We reviewed personnel files of the school's classroom teachers as of June 30, 2004 and interviewed school managers about the qualification verification process. We found that two of the school's nine teachers have a Hawaii state teacher license. Most of the seven remaining unlicensed teachers have not submitted evidence for their alternative qualifications or lack them altogether. In two cases, transcripts for a bachelor's or higher degree are not on file while the other five include only unofficial transcripts. Files of teachers with bachelor degrees show no evidence they have gone through a teacher preparation program and have teaching experience, both of which are minimum requirements. Several unlicensed teachers hired had no previous teaching experience or the school could not provide evidence of such.

The school acknowledged that teacher qualification documentation was substandard and could provide no assurance that the missing documents actually exist. We were informed, however, that the school puts each teacher through an evaluation process that includes close observation of the applicant's interaction with students, with a final hiring decision made only on satisfactory completion of that process. While this process may satisfy school officials, it does not meet requisite teacher qualifications set by the school's charter.

An additional concern is the school's compliance with minimum qualification standards for subject area competence established by the federal No Child Left Behind Act. The school could provide documentation for only two of nine teachers meeting this federal standard.

Oversight lapses compromise student health and safety

The Board of Education's award of a charter to Waters of Life Charter School without personnel policies and procedures laid the foundation for deficiencies in the school's management of health and safety issues. At Waters of Life, staff roles and responsibilities are unclear and record-keeping is spotty. Substantial numbers of verifications required during the hiring process were not performed or not documented in personnel files. A school manager acknowledged the problem and agreed that a checklist with all the needed steps and documentation should be part of the process.

Waters of Life Charter School is obliged under its charter to ensure that criminal and health checks are performed for every employee prior to employment. Moreover, the charter school law specifically provides that charter schools are subject to all state health and safety laws. We found that Waters of Life Charter School is not in compliance with either provision.

Personnel records do not include complete documentation of fingerprinting or on tuberculosis clearances for staff working in the proximity of children. Fingerprinting is required in order to perform criminal background checks. We reviewed 20 personnel files and found as few as six with tuberculosis certificates and three with fingerprinting documentation. At least two Waters of Life Charter School employees had failed to submit documentation required for employment eligibility under Department of Education rules. Criminal background checks and fingerprinting requirements are outlined in Chapter 8-7 of the Hawaii Administrative Rules (HAR) governing the Department of Education. Tuberculosis certificates are required under Chapter 11-164, HAR which guides the Department of Health's tuberculosis control program.

More worrisome is the lack of procedures to ensure safe bus services for children. We found that children have been transported, during a brief employment, by a driver with an extensive criminal record, including felony convictions in the first degree involving a minor. In addition, the school did not have required traffic abstracts, criminal history checks, or evidence of driver training on file for at least two of its four drivers. Children's safety may also be compromised because of the school's lax enforcement of drug-testing for bus drivers and reluctance to address known driver safety violations. A driver suspected of substance abuse was allowed to defer a drug test and continue driving a bus for the school. In addition, the local school board discussed "significant numbers of reports" about negligent driving by the same driver over several months before deciding not to rehire the employee. The school received complaints from parents about the driver, who also disregarded directions and was found unable to manage students on the bus. Notwithstanding, the driver was allowed to continue driving school buses. The school's prior director explained that the school "needed [the driver's] aloha;" however, this does not justify inaction where children's safety is at stake. Furthermore, the school risks incurring legal liability from any harm caused by employees who may be unfit to be entrusted with the welfare of children.

Failing to carry out or document reference checks exposes the school to additional legal liability. In our review of all personnel files, we found no evidence that the information received from prospective employees is verified as part of a reference check. Employment experts have found that substantial numbers of resumes contain false or exaggerated information. Guides on best practices in hiring state that reference checks are essential for making informed hiring decisions and avoiding negligent hiring claims. An employer is advised to contact past employers, verify information on resumes, check personal references, and investigate gaps in employment history.

The Department of Education's role is unclear

Relying heavily on the department for oversight functions and problem resolution, the Board of Education has not clarified its functions relative to the department. The result is confusing, sometimes duplicative, efforts in communicating with charter schools. The department created the Public Charter School Program primarily to administer federal funding to charter schools and coordinate department provided services. The department's program staff, however, carry out oversight-related functions such as visiting schools and notifying them of statutory or contractual compliance requirements.

Waters of Life's Disregard for Sound Governance and Business Practices Has Placed Its Continued Viability at Risk

The Waters of Life Charter School has experienced a series of problems that threaten its viability. These problems are a result of the school's leadership's inability to establish sound governance and financial management practices. For instance, the school's board lacks experienced members, clearly defined roles, and the expertise to plan for its future. Financial mismanagement and losses have occurred because the school lacks adequate records and qualified staff. The school's undesirable financial condition raises questions about its ability to meet its substantial financial obligations.

The concept of charter schools is based on the proposition that freedom to innovate and try unconventional ways of conducting school affairs may lead to new and better ways to operate a school. This freedom, however, does not relieve a charter school from responsibilities relating to stewardship of public funds that apply to all public entities. The U.S. Government Accountability Office⁹ established that accountability is key to our nation's governing process and that government officials are accountable to the public and legislative bodies. Therefore, agencies entrusted with public resources, including the Waters of Life Charter School, have an obligation to apply those resources effectively, efficiently, economically, and legally to achieve the purposes for which they were provided. Using sound management practices, maintaining effective management controls, and being accountable to administrators and the public are important features of an entity that meets this obligation.

Waters of Life Charter School's steady enrollment between 130 and 160 students in the last three years, up from 76 in school year 2001-02, is an indication that the school is meeting a need. Even critics of the school praise its staff for doing a good job with its students and being well-intentioned, hard-working, and dedicated. We heard anecdotal accounts of children doing well at Waters of Life Charter School after being in danger of failing at a traditional public school.

However, some of the same sources, all of whom are in a position to compare Waters of Life Charter School with other Hawaii charter school operations, also regard the school as poorly managed, with some characterizing the school leadership as “amateurish” and its business management knowledge having been “zero to none.” According to the former executive director of the Charter School Administrative Office, numerous potential donors are willing to help charter schools with financial and other support. However, these donors want to see a professionally governed board, a well-managed operation, and immaculate accounting before entrusting their resources. Waters of Life Charter School currently does not meet these expectations, hindering its fundraising capability.

The school’s prior director believed that the school was prudent in spending because every large purchase was discussed with the local school board and supplies were purchased on sale or at discount stores. In reality, however, this organization with close to a million dollars a year in state and federal funding has operated without the basic safeguards necessary to protect the school from errors, fraud, and losses. The board’s inability to plan and lack of business experience have jeopardized the school’s financial future.

Important first steps toward stabilizing the Waters of Life Charter School’s financial management include an overdue financial audit and significant changes to the composition and operation of its school board. The school board should be evaluated in light of best practices in governance and the by-laws amended to require a more experienced and diverse membership.

The school’s inability to plan and address governance defects has contributed to excessive cost overruns

Waters of Life Charter School’s local school board has not developed into an effective governing body for the school over its four-year history. Inadequate planning for major decisions by successive boards has resulted in continuous problems. The current school board, unable to establish leadership and lacking a sufficient level of experience and diversity, has not been able to make informed decisions and bring about desired changes. The resulting disorder has deterred experienced candidates from serving or continuing to serve as board members and led to ongoing problems that have negatively affected the school’s staff, enrollment, reputation, and financial viability.

Inadequate planning and lack of business knowledge prevent the school from overcoming adversities

Waters of Life Charter School’s board has a history of making major decisions without requisite information and expertise. Poor decisions ultimately lead to unanticipated problems and do not produce desired results.

The most evident planning failures involved school facilities. In its May 2000 detailed implementation plan, the school assured the Board of Education that it had located facilities and begun the permitting and inspection process. These assurances, made months before the school's expected opening, suggested there was ample time to address any permitting issues. Yet in August 2000, the school purchased a house in a residential neighborhood and began school operations immediately. Zoning laws, however, prohibited schools at that location and the County of Hawaii, responding to neighbor complaints, cited the school for a violation of its zoning laws. This forced the school to relocate to another facility.

A second property was purchased in 2001, consisting of three adjoining, unimproved parcels of land in the Hawaiian Acres development in Puna. The school spent over \$12,000 grading the land but never completed the original plan to erect school facilities at the site, at least in part because it faced unforeseen development expenses, such as fire protection requirements that were found to be too costly.

The school board proceeded to purchase another property in July 2003, a 28-acre farm with a structure including office space, an apartment, and a 6,000-square foot warehouse. Although the school planned to use this structure as a school for 131 students enrolled in school year 2003-04, neighbors frustrated the school's plans, stating that the site's agricultural zoning did not allow for a school without a permit.

As a result, the school has been able to use this property for an administrative office, but not for classroom instruction. The school is still committed, however, to pay the \$380,000 mortgage in addition to rent for several temporary classroom facilities in the area. School leaders are adamant that they were diligent in complying with all rules and laws in acquiring and seeking to relocate to the farm property. To the contrary, we found that the school board disregarded advice and sound planning practices in pursuing this major commitment.

Furthermore, the school's board ignored warnings regarding permits and failed to exercise due diligence as it committed the already financially strapped school to this purchase. The Hawaii County planning office had warned school officials that the office's belief that the school was not subject to state zoning requirements was subject to differing interpretations and urged the school to seek neighbor cooperation. The school board discussed but decided not to inform neighbors of its intention prior to finalizing its purchase "to avoid stirring things up."

Consequently, neighbors' concerns regarding a school in their neighborhood did not surface until the purchase was final. Having ignored the county's advice, the school is now embroiled in a lawsuit

with its neighbors and faces having to obtain a special permit prior to occupying the farm school site. In addition, no plans or professional assessments from an architect, attorney, or accountant were obtained prior to purchasing the property. Such professional advice would have reduced the risk of unexpected problems and costs in converting a warehouse into a school while complying with all requirements to obtain a certificate of occupancy. It also would have ensured that committing to the project was prudent and within the school's means.

Another example of the local school board's inadequate planning is the timing of the ill-fated move to the newly acquired farm school property. The school publicly advertised as early as July 13, 2003 a school start date of August 21 at the new location, when the purchase contract was not even finalized. The sale did not close until July 28, 2003, and the school did not consult the county planning office about permitting and occupancy certification requirements until the day of closing. It was only then that the school learned its projected start date had been overly optimistic, despite the county's agreement to process the school's plans in a timely fashion.

Guidelines for a prudent approach to facilities acquisition are readily available from numerous sources. For example, the *Illinois Charter School Developer's Guide*¹⁰ advises an assessment by a qualified architect before any commitment is made to obtain reliable estimates of renovation costs. The guide also recommends the use of professional services not available from board members, including commercial real estate agents, building inspectors, general contractors, financiers and lawyers, adding that this is not an area to skimp. Other charter school guides for facilities planning recommend that schools use care and expertise to identify significant risks early and plan to complete any modifications before school starts.

The local school board lacks experience and diversity

Since its inception, Waters of Life Charter School's board has lacked members with experience in business and a diversity of backgrounds. This inexperience and lack of diversity appears to have fostered the school's financial mismanagement, which in turn impaired its ability to strengthen board membership. The school's business management shortcomings have discouraged some well-qualified candidates from joining the board. One former board member resigned upon seeing no prospect for improvement.

According to leading charter school guides, optimally balanced school boards need members with skills in areas such as finance, facilities, governance, fundraising, human resources, law, and public relations. These guides also suggest limits on board membership by employees as

this can create a conflict of interest. The Minnesota Council on Nonprofits guide¹¹ suggests that no more than one employee be allowed on a board. A Massachusetts charter school board guide¹² also discourages parent representatives on the board unless they possess skills that broaden the school board's diversity and competence. The guide explains that an individual parent cannot speak for all parents and the board should have a better means to ensure parents' concerns are considered. One charter school board chair stressed the importance of having members who are emotionally detached from day-to-day operations.

The Waters of Life Charter School has not made concerted efforts to recruit experienced members from the community. While other charter school boards have attracted community members who contribute experience in business or viable boards, the Waters of Life board has lacked such experience. One chairperson, for example, had never served on a board before and was elected to the position within weeks of becoming a member. Leaders involved with successful Hawaii charter schools assert that well qualified board members can be readily found if a school enjoys a reputation for good management. The *Massachusetts Charter School Trustee Guide*¹³ stresses the importance of cultivating quality leadership:

An astute board chair will cultivate and nurture board members who have the expertise and the personal qualities the organization needs. Preparing board members for future leadership positions is critical to an organization's continuing viability.

We found that the composition of the Waters of Life Charter School's board has contributed to the school's financial problems. Major decisions have been made without a quorum, possibly involving conflicts of interest, and board members have made decisions without needed data. Some members have merely rubberstamped prior directors' proposals.

At the time of our fieldwork in June 2004, the school board consisted of nine members: five school employees, including the prior director, and four parents. Three positions provided in the by-laws, two for community members and one for a parent member, were vacant or filled by a school employee. Attendance by the parent members was wanting, with one or two absent at most meetings during FY2003-04. The board's majority, consisting of the five employees, made most of the decisions. This school board composition is flawed and inconsistent with best governance practices. Having the director also be a member of a board which consists primarily of employees creates the potential for both domination of the decision-making process and conflict of interest. In

fact, past and present board members indicated that successive directors have generally dominated the school board, sometimes with the help of one or two other board members.

The school's board has voted on several major decisions when it did not have a six-member quorum as required in its by-laws and failed to document in its minutes whether conflicted members abstained from voting. Over a five-month period ending in March 2004, we found at least four major decisions that were voted on when the board did not have a quorum.

In November 2003, five members—the prior director, three employees and a parent—voted to raise the prior director's pay and agreed that she would write her own employment contract. The board minutes do not indicate whether the prior director abstained from voting on these decisions, although she would be prohibited from doing so under the school's by-laws. In addition, a business belonging to the school was transferred to the chairperson and his spouse. Again, the minutes do not reflect whether the chairperson abstained from voting. We were informed that the intent of the transfer was for the chairperson and spouse to grow the business and return it to the school after the school had been established as a non-profit organization; however, this intent was not formulated in a written contract.

In January 2004, five members elected four new board members and determined that the school would move to a year-round calendar. A week later, five members elected a treasurer and assigned check-writing privileges. Finally, in March 2004, four members made significant spending and hiring decisions. All of these decisions lacked the required six-member quorum.

Some of the current and former members stated that they did not receive adequate information to make informed decisions at board meetings and that some members' practice to "go along" effectively allowed the director to run the school unchallenged. One member explained, "We went on the recommendations of those three people [the director and two board members] who knew what they were doing," when justifying approval of proposals relating to a \$405,000 property purchase that subsequently led the school into litigation, unexpected costs, and disruption. Board members confirmed that such a rubberstamping tendency has been common under successive administrations.

Rubberstamping violates a board member's duty of exercising reasonable care when making a decision and may be a result of the lack of training and succession planning provided to the school's new board members. None of the current or former members we interviewed, some of whom have never previously served on a board, received training upon

assuming their responsibilities. For example, the treasurer at the time of our fieldwork felt unqualified for the position but was appointed without any training. This member believed that the major function of the treasurer is to countersign checks. According to the school's by-laws, however, responsibility for the school's accounts, revenues, disbursements, and preparation of reports on numerous financial transactions rests in the treasurer's hands.

Muddled roles cloud responsibilities of the school board and the director

The Charter Friends National Network's guide¹⁴ for local school boards reports that many charter schools have been plagued by governance problems, including entanglement with issues that should be handled by the director. Charter school board responsibilities generally include governance functions, such as defining the school's mission and direction, hiring and supervising the director, planning, raising funds, ensuring legal and ethical integrity and accountability, and recruiting new board members. The Waters of Life Charter School's by-laws state that the school board must delegate day-to-day operations, but we found that board members have been deeply involved in day-to-day decisions normally assigned to the executive, in this case the school's director. Prime examples are the hiring of staff and day-to-day supervision of financial recordkeeping activities.

Minutes indicate that the school board not only makes hiring decisions but also discusses new hires' remuneration and employment conditions, both generally executive functions. After decisions are made, no one bears responsibility for documentation and follow-up to formalize arrangements. In one case, months after hiring, a dispute arose with an administrative employee about the agreed upon salary. The school had no written documentation on the original remuneration or employment conditions. When asked to explain the situation, the individual who was director at the time referred us to board minutes, which did not provide these details. Even when faced with evidence of the defective process, this director did not take responsibility for the loss to the school from overpaying the employee.

Similarly, a former school board member closely supervised the school's day-to-day financial activities, which would normally be the responsibility of the director. Upon the retirement of the school board member without the training of a successor, the accounting responsibilities ended up entirely in the hands of a clerical level employee who had no supervision, guidance, or controls over her activities. School officials suspect this employee of having made unauthorized expenditures.

Thousands of dollars in uncollected advances have not been pursued while neither the director, the accounting clerk, nor a former board member in charge of accounting could agree on whose responsibility it was to manage these accounts. For example, \$2,500 in salary advances has remained uncollected for two years although the school has the debtor's written authority to withhold. While staff claimed collecting advances was handled by the school board, the board member expected it to be an administrative responsibility.

Inadequate fiscal management and controls cloud the school's financial viability

The Waters of Life Charter School has a history of ill-conceived management processes and lacks the expertise needed to run an effective business operation. Although some improvements have been made, we found that the school cannot produce accurate, complete, and meaningful financial reports to account for the use of state and federal funds, assess its financial condition, or provide its school board with competent financial data. In addition, an effective systematic management controls has not been developed and implemented. This is an essential responsibility of prudent management and ensures reliable financial reports, effective and efficient operations, and compliance with applicable laws and regulations. While school leadership professes to “turn every penny” in making spending decisions, it has not obtained the expertise needed to establish safeguards to protect the school from loss, fraud, and waste, which threaten its survival and long-term viability.

School leaders contend that the school lacked the financial resources to hire better qualified staff as well as legal and accounting services; and a former school board chair cites the lack of “equitable funding” from the State as the cause. However, other Hawaii charter schools have balanced their resources between academic and administrative needs and operate without the financial hardships encountered by the Waters of Life Charter School. Some of these schools are of comparable size and serve the same geographical area.

At its opening in August 2000, the Waters of Life Charter School lacked a plan and the basic controls needed to properly and prudently conduct its business affairs. Its founders lacked the knowledge needed to organize and operate a school with an annual \$750,000 budget. This resulted in avoidable mistakes that contributed substantially to the school's subsequent financial problems, including overspending the state funded allocation by more than \$250,000 in its first two years of operation.

The deficit occurred because the school failed to track and record the salaries paid by the Department of Education on its behalf. The department provided the school with reports showing the amounts paid but these amounts do not appear on the school's accounting records. The

school is repaying the amount to the department over five years. According to a former school official, discovery of the deficit was a surprise to the school and it placed blame on the department. However, other charter schools in the same situation did not overspend—an indication that the problem resulted from Waters of Life's inadequate financial management and controls.

Further, we found that the school cannot account for its first state funding installment of \$150,000, which was expended between August 5 and October 3, 2000. The school has no receipts for this entire amount; in fact, its first documented expenditure is dated November 14, 2000. Checks for thousands of dollars were issued to individuals associated with the school who did not substantiate their spending.

In addition to lacking documentation, basic safeguards such as a countersignature on checks were missing, allowing, for example, a \$15,850 check to be made out in the principal's name, signed by the principal without countersignature, and lacking documentation as to the purpose of the payment. The school did not use printed checks between August and December 2000. During this time, payments were made on hand-numbered checks with numerous gaps, including duplicate and triplicate check numbers, and unnumbered payments. As a result, it is impossible to verify that all payments have been accounted for.

Poor fiscal management has burdened the Waters of Life Charter School from the outset and is still reflected in its substandard accounting practices and passive financial leadership. The school needs to improve its financial reporting capabilities, procedures, and administrative competence to reduce unanticipated losses and costs and stabilize the school's finances.

Defective financial reports provide little useful information to school leaders

An incomprehensible chart of accounts is a major factor in the school's inability to account for its use of public resources and provide its school board with information essential for sound decision-making. Former school board members attest to the dearth of useful financial information.

A well-designed chart of accounts is the foundation for useful and informative financial reports. Used to categorize and track financial transactions, a chart of accounts defines the reports available to make financial decisions. Waters of Life's chart of accounts has not been properly tailored for use by a school and consists of a confounding collection of accounts, even referred to by the former director as "random." Simple charts of accounts use account names such as

“salaries,” “office supplies,” or “bank fees.” More complex methods assign a number to each account, such as “4000-salaries,” “4030-office supplies,” or “4080-bank fees.”

The ill-conceived Waters of Life’s chart of accounts, however, uses both methods in the same chart. Unnecessary accounts have been created for single transactions such as “banking error,” “sale of trampoline,” or “computer shelves,” thereby cluttering the chart and adding no discernible benefit. The chart also includes duplicate accounts, including at least seven accounts to record bank fees and credits. Appendix A shows the chart of accounts currently used by the school. The school should consider existing models for improving its accounting system. For example, the National Center for Education Statistics has issued guidelines for classifying revenues and expenditures in public school systems that meets the specialized needs of schools and also generally accepted accounting principles for government entities.

The schools’ accounting software package does have a budget feature allowing the production of variance reports, which is helpful for the school board and school managers when comparing budgeted with actual revenues and expenditures. However, this feature is not used by the school. Its use would require the budget to be prepared in a form that matches the chart of accounts, which is not feasible until the chart of accounts is revised.

A lack of accounting procedures and qualified financial administration have resulted in inaccurate and incomplete financial records

The Waters of Life Charter School’s failure to develop written accounting policies and procedures and hire knowledgeable staff indicates that the school’s leaders either lack the expertise to recognize the importance of proper financial management or have not assigned an appropriate priority to fiscal accountability. We identified numerous problems related to this longstanding deficiency, including large discrepancies in the financial records, weak controls to protect the school from financially costly errors, and violations of law and prudent business practices.

Unsound accounting practices have resulted in an estimated \$750,000 understatement of revenues and expenditures over four years, at least in part because combined transactions have been recorded as net amounts. When the Department of Education, for example, deducts money owed from state funding allocations, the school improperly records the net amount received, understating both revenues and payroll expenses.

To illustrate, in August 2003, the department allocated the school \$342,720 in state funding, but deducted \$107,298 for unpaid payroll, fringe benefits, and administrative fees from that amount. The school's accounting records inaccurately reflect only the net amount remitted, \$235,422. The distortion of the financial records from such practices can cause future budget shortfalls if these understated expenditures are used for projecting future funding needs.

Financial mismanagement has caused waste and losses

Poor controls also expose the school to waste and loss. Examples include insufficient documentation for expenditures, excessive concentration of employee control over records, not using built-in safeguards of the accounting system, and lax controls over salary advances and pay raises. In our review of accounting transactions, we found the school's documentation and record keeping practices inadequate.

Among the numerous problems we encountered are check amounts that differ from supporting documentation without explanation; unsigned and unauthorized expenditure request forms; insufficient documentation to determine the purpose and appropriateness of expenditures without further inquiry; and checks made out to persons different from those named in supporting documentation. Further, a voided check was found in an expenditures file rather than with cancelled checks; expenditure documentation for the same vendor and for the same purpose is located in multiple files. Adding to the disorder, the school's payment records are filed according to confusing account names, making it difficult to find documentation for a specific payee or to research propriety of expenditures. Typically, accounts payable files are arranged alphabetically by the names of vendors.

Furthermore, fixed assets are not adequately controlled and accounted for. Maintaining records for fixed assets—long-lived purchases including buildings, furniture, and equipment such as computers—is essential to demonstrate accountability of new additions, transfers, and disposals. Periodic physical inventory checks should be performed to ensure their accuracy, including identification of asset descriptions and information on the purchase date.

The school generally documents newly acquired assets as expenditures but does not maintain fixed asset-specific records such as an inventory listing, making it impossible to perform periodic checks. The State has a special interest in accurate fixed asset records, as it has first right to these assets in the event of a school closure. Should the school move forward with planned construction projects, accounting requirements will become

more complex and may be beyond the school's current capabilities. The school should familiarize itself with generally accepted accounting practices before entertaining such projects.

At the time of our fieldwork, a single employee recorded, prepared, reviewed, and entered all expenditures into the accounting system. The same employee also performed all reconciliations and in effect had complete control over all accounting activities without supervision. This is a serious management control weakness as it excludes any systematic measure for deterring and detecting errors and irregularities. In fact, school leaders found indications that this employee may have caused losses to the school from unauthorized payments but lacked the documentation to make a positive determination. Such situations can be prevented by implementing proper management controls—processes to safeguard an entity's resources—and segregating accounting duties so that authorizing, processing, recording, and reconciling transactions are not performed by the same person.

In addition, the Waters of Life Charter School is not using important features of its Quick-Books accounting software such as the audit trail and budget features. Quick-Books, essentially an electronic checkbook, allows retroactive changes to be made without a trace. For example, a discrepancy can be hidden by improperly modifying the amount of a check recorded several years ago. This accounting software would not trace such an action unless the audit trail feature is activated. The audit trail feature maintains a record of every change made, allowing retroactive changes to be discovered. Using the audit trail feature may cause the computer to operate more slowly and requires more electronic storage capacity but provides a record of every change made to the financial records.

We also found weaknesses in the school's handling of independent contractors and documentation and payment of mortgage interest.

In May 2004, the Department of Labor informed the school that for unemployment insurance purposes, several independent contractors hired by the school were in fact deemed employees because their activities and duties were comparable to those normally performed by employees. In July 2004, the school still had at least one independent contractor, who was misclassified under both state and federal laws. Employing independent contractors is attractive to employers because they would not have to pay payroll taxes, withhold and remit income taxes from wages, and provide employee benefits. But it found to be in violation, the employer becomes subject to significant penalties for violating employment tax law and liable to the employee for failing to provide employee benefits.

Moreover, the school's accounting records also indicate that state and federal funds were used to support a business owned by the spouse of a school board member. Over \$11,000 in school funds have been expended on the business, including \$7,500 for a consultant to teach the owner how to operate the business, with over \$6,000 of these expenditures inappropriately made from a federal grant. In addition, the business uses but does not reimburse the school for facilities, electricity, telephone, and water services. Even though the school is intended to assume ownership of the business in the future and benefit from any profits, expending state and federal funds for a business currently unrelated to the school is improper.

Finally, the school does not accurately track and maintain records of financial activity on its \$380,000 farm mortgage, inviting adverse consequences and placing the school at risk. In response to our inquiry for principal and interest payment records, the school presented a payment schedule for different amounts and terms than those specified in the mortgage.

Responsible school employees could not find documentation for payments made and could not explain how payment amounts had been determined. Entries in the school's financial reports were inconsistently classified and not clearly identified, allowing only guesses as to what had actually been paid. Our computations of required principal and interest payments according to the mortgage terms and best estimates of actual payments from accounting reports indicate that the school has been in default twice. Payments made in November 2003 were \$1,809 less than the agreed amount and 20 days late. Payments made in February 2004 were five days late, although that payment included a \$1,256 overpayment.

A default clause of the mortgage terms provides that if a payment is not made when due, "the Note holder will require [the school] to pay immediately the full amount of principal which has not been paid and all the interest that [the school] owe[s] on that amount." Consequently, the school has been exposed to the risk of having to pay the entire mortgage balance on two occasions, an obligation it does not have the means to fulfill. While school leaders have a tendency to blame third parties for the school's misfortunes, their failure to protect the school from avoidable impairments significantly contributes to the legal and financial setbacks encountered by the school.

The school's lack of control over salary advances made to employees has cost the school an estimated \$10,000 over four years. The school made numerous loans to employees, totaling an estimated \$56,000. While salary advances provide assistance to teachers who must wait up to two months for the Department of Education to process a pay check after

hire, some advances were actually loans, a questionable use of public funds. We were unable to determine who at the school was responsible for tracking and ensuring that these advances and loans were repaid. The school administrative services assistant informed us that the school board was responsible for managing advances while the prior director and a former school board member asserted that it was the responsibility of the school administrative services assistant. Not surprisingly, we found a \$4,000 loan outstanding for over two years that was recoverable but had not been pursued.

During our audit work, the director reported discovering that the school administrative services assistant was paid a significantly higher salary than warranted. This clerical position was paid at a level comparable to a teacher with a master's degree. The school leadership suspected that the unsupervised employee in charge of all financial activities may have given herself successive unauthorized pay increases. However, this could not be proven because the school has no employment memorandum on record that documents the employee's original salary and other specific employment conditions at the time of hiring. Therefore, the school could not confirm that the employee's salary had in fact been improperly increased.

Projections for meeting large financial obligations may not be realistic

The Waters of Life Charter School is committed to repay the Department of Education \$257,000 for a budget overrun. The repayment schedule provides for \$40,000 per fiscal year through June 2007, with a final payment of \$81,000 in September 2007. In addition, as of June 2004, the school carried forward a deficit estimated at \$70,000 from FY2003-04. The prior director contends that this deficit was incurred and had been carried forward from prior years but could not provide any evidence to support this claim.

In light of the deficit and funds committed to repayments, concerns arise about the school's ability to service a \$380,000 mortgage for a property currently the subject of legal and permitting complications. In committing to the debt, school leaders did not obtain a financial feasibility analysis from a professional. The mortgage was signed with the seller of the property as the school's precarious financial condition precluded a bank loan. Payment terms require \$50,000 per year with a balloon payment of \$135,000 in November 2008. The school has no long-term financial plan for meeting these substantial commitments. From interviews, we found that school leaders counted on unspecified grants and the profits from a business that was donated to the school to raise the funds needed. Currently, however, neither of these revenue sources are guaranteed.

In obtaining grants for the substantial amounts needed, the school faces much competition and the reluctance of some potential donors to get involved with an organization whose financial records are suspect.

The business currently does not make enough money to cover a salary for its manager. In addition, it has benefited from state subsidies in the form of consulting services, facilities, and utilities paid from school funds. The business, which consists of marketing and selling tropical plants and related products, is in a market that is mature and competitive. To add to the uncertainty, a plant-based business can be harmed by diseases and bad weather, and the current manager has no business experience. Therefore, profit growth is not guaranteed.

Other revenue sources may be limited as the school's non-government collections totaled only \$25,000 over four years. The school's unused real property, purchased in 2001 for \$30,000, could be sold.

The situation is made more critical with the upcoming end to the \$150,000 federal start-up grants received in each of the past two school years. The school could not provide us with a plan for wrestling with the financial issues. A financial audit and thorough professional analysis of the school's fiscal status, revenue prospects, and operations are needed to determine the school's ability to service its debts and ascertain its long-term financial viability.

Conclusion

Flaws in the charter school law and the Board of Education's passive approach to its responsibilities as authorizer of Hawaii charter schools have contributed to the Waters of Life Charter School's continuing financial and management problems. More importantly, the school's passive governance and inadequate financial management perpetuate unsound management controls and practices established by the school's founders. The school's failure to account for its actions leaves the Board of Education and the public unable to assess the school's stewardship for \$2.6 million in public funding and fulfillment of its charter contract. A financial audit and analysis is needed to answer questions about the school's long-term viability. Only sweeping changes to its governance and financial management will allow the school to right itself onto a financially stable course.

Recommendations

1. The Legislature should enable the Board of Education to establish a committee or panel of experts and stakeholders to identify and recommend to the Legislature revisions to the existing charter school

law in order to create an effective framework for overseeing and supporting new and existing charter schools. At a minimum, these recommendations should address:

- a. Powers, authority, and requirements of schools, local school boards, the Charter School Administrative Office, and the Board of Education, including responsibility and authority to impose sanctions when a charter school fails to comply with contractual and/or statutory requirements; authority for and management of technical support and interventions, including mergers and closure of charter schools and transfer of students to other public schools; and the ability to impose accountability measures for all charter schools, such as appropriate accreditations and adherence to generally accepted government accounting standards;
 - b. An application and start-up process for charter schools requiring sufficient time and proper scrutiny to ensure a school's readiness prior to accepting students;
 - c. Limitation of charter school exemptions from laws to only those laws applying to public schools;
 - d. The State's rights and liabilities where charter schools or their governing corporate bodies acquire real property or conduct for-profit business activities, including clarification of charter school's authority to incur debt and the State's responsibility in case of default;
 - e. The conflict of interest inherent in the charter school administrative director position;
 - f. Eligibility, administration, and funding of state benefits for non-certificated employees of charter schools; and
 - g. Feasibility of assisting charter schools with facilities needs, including priority access to any vacant government buildings suitable for conversion to a school.
2. The Board of Education should:
- a. Establish clear strategies, rules and regulations for its oversight of charter schools. These should address probation and revocation criteria and processes as well as crisis intervention;
 - b. Require charter schools to provide verified and periodically updated listings of fixed assets; and

- c. For any future new charters, include experts in business and finance in evaluating an applicant's readiness to administer its affairs. The charter should include a section outlining the board's expectations of the school and the consequences of non-compliance.
- 3. The Board of Education and the Charter School Administrative Office should develop appropriate programs to foster the exchange between charter schools of proven solutions to common operational problems, including training and networking exchanges. Such programs may include a peer review program for all Hawaii charter schools.
- 4. The Waters of Life Charter School should:
 - a. Ensure that hiring practices comply with its detailed implementation plan, prudent personnel practices, and all safety and health related requirements;
 - b. Constitute and operate its school board in a manner consistent with recommended practices and ensure that new school board members receive appropriate training;
 - c. Acquire competent business staff, capable of establishing and maintaining financial records in accordance with generally accepted accounting principles and contract for an independent financial audit to establish its fiscal status and viability;
 - d. Adopt written policies and procedures for accounting, personnel, and a procurement process consistent with the goals of public accountability and prudent procurement practices;
 - e. Budget for competent professional advice in legal and financial matters when in-house expertise is inadequate; and
 - f. Ensure that independent contractors are not improperly classified as employees, seeking guidance from the Internal Revenue Service if necessary.

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Appendix A

Chart of Accounts Waters of Life Charter School

Ordinary Income/Expense	Hospitality	Sewer - Boys & Girls Club
Income	lunch	6400 - HELCO
DOE Carryover '02-'03	Maintenance	Boys & Girls Club
DOE Charter School Funds	Cleaning of facilities	Sunshine Farms
federal impact aid	Maintenance - Other	
Federal Sub-Grant		Total 6400 - HELCO
Salary advance repayment	Total Maintenance	
Special Education	membership dues	6410 - Water
Staff Emergencies	Mileage reimbursement	Boys & Girls Club
Title 1 Funds	overpayment of reimbursed exps	Girls Scout
4110 - Grants	professional development	
4150 - Miscellaneous Income	property tax	Total Boys & Girls Club
A+, lunch monies, & Donations	Registration Fee	
4150 - Miscellaneous Income - Other	reimbursement	Sunshine Farms
	rennovation	6410 - Water
Total 4150 - Miscellaneous Income	repayment of grant loan	
	Returned Check Fee	Total 6410 - Water
Total Income	Rubbish Removal	
Expense	salary advance	Total 6390 - Utilities
Administrative	school development	
Database Mgmt	school supplies	6450 - Payroll
Administrative - Other	Stipend	Advancement
	stop payment on checks	Bus Driver Salary
Total Administrative	T-shirts	Wage & Hour Claim
	teacher supplies	Bus Driver Salary - Other
Administrative Staff Development	tech lab site developer	
advertising	tech supplies	Total Bus Driver Salary
airfare	6120 - Bank Service Charges	
alarm system	6160 - Dues and Subscriptions	DOE
Architectural Services	6170 - Equipment Rental	DOE fringe benefits
septic system	Office	Federal Withholding
Architectural Services - Other	Truck for hauling	Food Service Program
		FUTA
Total Architectural Services	Total 6170 - Equipment and Rental	Salary payment
		State Unemployment
association dues	6180 - Insurance	State Withholding
BANK DEBIT	Bus	6450 - Payroll - Other
Bus	Workman's Comp	
bus supplies	6190 - Temporary Disability Insurance	Total 6450 - Payroll
Drug Test		
Fuel	Total 6180 - Insurance	6770 - Supplies
Inspection		alternative facility & rennovation
Registration	6200 - Interest Expense	classroom supplies
Repairs	6375 - Mortgage	copier supplies
	6200 - Interest Expense - Other	farm
Total Bus		maintenance supplies
	Total 6200 - Interest Expense	office supplies
computer lab		6771 - Audio/Visual Equipment
computer program	6240 - Miscellaneous	6773 - Cleaning
Computer tech program development	6250 - Postage and Delivery	6774 - Computer
Computer Tech Services	6260 - Printing and Reproduction	6776 - First Aid
Conference Fees	6270 - Professional Fees	6778 - maintenance
Contract Labor	6280 - Legal Fees	6790 - Office
Director	6650 - Accounting	6770 - Supplies - Other
Farm		
Contract Labor - Other	Total 6270 - Professional Fees	Total 6770 - Supplies
Total Contract Labor	6290 - Rent	Total Expense
	Ainaloa Community Association	Net Ordinary Income
copier rental	Bahai Center	
Counseling Services for curriculum	Girls Scout Center	Other Income/Expense
curriculum materials	gym	Other Income
Deficit '00-'01, '01-'02	HACA Center	Abbey Jones refund
Distance Learning Curriculum	Waieka Uka gym	banking error
E-School		farm Donation
Equipment Purchase	Total 6290 - Rent	kokua i na kula
Building		loan from M. Barnes
computer shelves	6340 - Telephone	lunch reimbursement
Office	Boys & Girls Club	special education supplies
School	cell phone	
	Internet	Student Services
Total Equipment Purchase	Sunshine Farms	7010 - Interest Income
farm consultant	Total 6340 - Telephone	Total Other Income
Farm Site Development		
Farm supplies	6350 - Travel	Other Expense
farm tools	6380 - Travel	bank credit
field trip		checks
fire hydrant test	Total 6350 - Travel	
food permit		Total Other Expense
Food Service Program	6390 - Utilities	
grantwriting services for capacity	Ainaloa Community Association	Net Other Income
health & safety	Girls Scout Center	
health insurance	Port-a-Potties	Net Income

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Notes

Chapter 2

1. Letter to Lincoln S. T. Ashida, Corporation Counsel, County of Hawaii, from Joanna Fong, Deputy Attorney General, State of Hawaii, October 22, 2003, p. 2. The letter interprets Section 302A-1184, HRS, as exempting new century charter schools from state laws that relate to the regulation of education, but subjecting them to laws that apply to the general public and other state agencies.
2. National Association of Charter School Authorizers, “Principles and Standards for Quality Charter School Authorizing,” adopted by membership, May 14, 2004, p. 7.
3. Arizona, Office of the Auditor General, *Performance Audit: Arizona State Board for Charter Schools*, Report No. 03-07, Phoenix, AZ, August 2003, pp. 31-32.
4. Letter to Nelson B. Befitel, director, Hawaii Department of Labor and Industrial Relations, from Frances E. H. Lum, Deputy Attorney General, State of Hawaii, November 20, 2003, p. 1. Letter states that charter school employees are state employees.
5. Marci Cornell-Feist, “Massachusetts Charter Schools Trustees Guide,” Massachusetts Charter School Resource Center at Pioneer Institute, http://www.pioneerinstitute.org/pdf/trustees_guide.pdf, no date.
6. C. Allison Jack and Margaret Lin, *Illinois Charter School Developer’s Handbook*, Third Edition Fall 2003, <http://www.lqe.org/Resources%20and%20Links/Handbook.pdf>.
7. National Association of Charter School Authorizers, “Principles and Standards for Quality Charter School Authorizing,” adopted by membership, May 14, 2004, pp. 4-5.
8. Brian Jacobs and Steven Levitt, “Catching Cheating Teachers: The Results of an Unusual Experiment in Implementing Theory,” National Bureau of Economic Research, working paper no. W9414, January 2003.
9. U.S. General Accounting Office, Government Auditing Standards, 2003 revision, p. 9.

10. Jack and Lin, p. 114.
11. "Governance Basics," Minnesota Council on Nonprofits, http://www.mncn.org/info/basic_gov.htm#board%20recruitment.
12. Cornell-Feist, p. 15.
13. Cornell-Feist, p. 20.
14. Frank Martinelli, "Charter Schools: Creating Effective Governing Board," Charter Friends National Network, http://www.uscharterschools.org/gb/governance/governance_summary.pdf, no date, p. 2.

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Board of Education, the Department of Education, the Charter School Administrative Office, and the Na Wai Ola Waters of Life Charter School on December 30, 2004. A copy of the transmittal letter to the board is included as Attachment 1. Similar letters were sent to the department, the administrative office, and to the school. All responded to the draft. The responses of the board, the department, the administrative office, and the school are included as Attachments 2, 3, 4, and 5, respectively. In Attachment 5, the school's response, we redacted the names of school personnel to preserve their privacy interest.

While generally agreeing with our report, the responses included some disagreements and several suggested clarifications.

Waters of Life Charter School disagreed with our conclusions on teacher qualifications, contending that eight of its nine teachers meet the requirements of the school's charter. The school's personnel files we reviewed lacked documentation to support the claim and school officials could not provide the missing documents when asked. According to the Department of Education, charter school teacher contracts may be processed without complete verifications, as the department cedes responsibility for that function to the charter schools. While the school does employ three licensed teachers, our analysis was focused on nine personnel listed by the school as classroom teachers. A licensed teacher performing administrative functions was not considered in our conclusions.

The school also stated that equipment was bought for the school with farm business revenues as compensation for rent and use of facilities. Further, it contends that at no time were school funds used for farm salaries, supplies, and equipment. Our assessment is based on documentation and school officials' explanations made available to us. Our report states that using public funds in support of an unrelated business is improper. The school's records and explanations of these records from school officials confirm that such improper transactions took place.

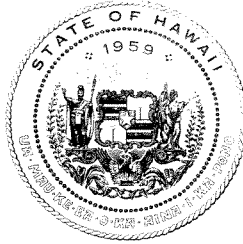
The Board of Education objected to our conclusion that it used the vaguely worded charter school law to justify its passive oversight over Waters of Life Charter School as excessive and unwarranted. Specifically, the board stated that the confusing law and advice from its

attorneys precluded it from fulfilling its role as the authorizer of charter schools, thus resulting in the reported shortcomings. We stand by our conclusions for the reasons detailed in the report. The State Constitution empowers the board to formulate statewide educational policy for charter schools. We contend that the constitution demands action by the board. Rather than merely reacting to the limitations of the charter school law, we maintain that the board should, with the aid of its counsel, craft amendments to the charter school law that will achieve the board's vision of its authorizer role.

Both the department and the Board of Education requested that we clarify in the report that they were not responsible for the illogical assessment of employee benefits costs, pointing out that the Department of Budget and Finance assesses these charges. We were unable to determine how exactly this problem arose and do not seek to assign blame. However, resolving this problem may require cooperation across departmental boundaries.

Finally, we included some clarifications in the report based on suggestions from Waters of Life Charter School and the Department of Education.

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

December 30, 2004

COPY

The Honorable Breene Y. Harimoto, Chair
Board of Education
Department of Education
Queen Liliuokalani Building
1390 Miller Street
Honolulu, Hawaii 96813

Dear Mr. Harimoto:

Enclosed for your information are 14 copies, numbered 6 to 19 of our confidential draft report, *Audit of Na Wai Ola Waters of Life Charter School*. We ask that you telephone us by Wednesday, January 5, 2005, on whether or not you intend to comment on our recommendations. Please distribute the copies to the members of the board. If you wish your comments to be included in the report, please submit them no later than Monday, January 10, 2005.

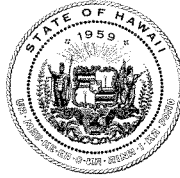
The Department of Education, Charter Schools Administrative Office, and Na Wai Ola Waters of Life Charter School, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa
State Auditor

Enclosures



**STATE OF HAWAII
BOARD OF EDUCATION**

P. O. BOX 2360
HONOLULU, HAWAII 96804

January 10, 2005

RECEIVED

JAN 12 10 05 AM '05

OFFICE OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the opportunity to comment on the confidential draft report, *Audit of Na Wai Ola Waters of Life Charter School* (report). The Board of Education (Board) values your findings, comments, and recommendations, and appreciates the time spent by your staff in conducting the audit.

The Board agrees with your findings that "Hawaii's faulty charter school law impedes accountability and effective support" and "The Waters of Life Charter School's disregard for sound governance and business practices has placed its continued viability at risk." However, the Board does not agree with your finding that "The Board of Education lacks a proactive strategy for overseeing the Waters of Life Charter School."

The Board of Education takes its role as the authorizer of charters seriously and while the Board agrees that improvements in its role can be made, it does not use, as the audit states, "...Hawaii's vaguely worded charter school law to justify its passive oversight over charter schools." In fact, the Board had and continues to have numerous discussions with the attorney general regarding its role and authority based on the charter school law (Chapter 302A, Part IV, Section D, Hawaii Revised Statutes – New Century Charter Schools). In asserting its authority, the Board wants to ensure that it operates within the boundaries of the law and does not unnecessarily expose the State and its taxpayers to lawsuits by failing to adhere to advice given by the attorney general. The audit clearly recognizes the Board's difficulties in obtaining legal direction, as the report states that the attorney general has not been consistent in its interpretation of the law regarding charter schools need for compliance with State laws. The report also indicates that the Office of Information Practices opinion on the law conflicts with the attorney general's more recent opinion by concluding that "...charter schools are indeed exempt from *all* applicable state laws, including sunshine laws." If State entities

responsible for legal opinions on laws are unable to agree on interpretations of the charter school law, it is unreasonable to expect the Board to easily determine its role in relation to charter schools. The report's accusation that the Board is taking advantage of a "...vaguely worded charter school law to justify its passive oversight over charter schools" is excessive and unwarranted, as the report concludes that there are concerns with the charter school law and states, "The confusion surrounding the law suggests a need for clarification."

The Board has been hampered in its role due to "Hawaii's faulty charter school law...." Section 302A-1182, Hawaii Revised Statutes (HRS), states:

The board shall have sixty days to review the completed implementation plan for the proposed new century charter school to ensure its compliance with sections 302A-1182 (c) and 302A-1184. Unless the board finds that the plan conflicts with section 302A-1182(c) or 302A-1184, the governor, the superintendent, and the board shall issue a charter designating the proposed new century charter school as a new century charter school within sixty days, and the proposed implementation plan shall be converted to a written performance contract between the school and the board.

The attorney general advised the Board that, as long as no conflict existed with Section 302A-1182(c), HRS, or Section 302A-1184, HRS, the law provides for an automatic conversion within 60 days of the proposed implementation plan to a written performance contract between the school and the Board, regardless of Board authorization.

Prior to finalizing Waters of Life Charter School's implementation plan, numerous communications occurred between the Board of Education, the Department of Education (Department), and Waters of Life Charter School. The communications focused on concerns that the Board had regarding Waters of Life Charter School's proposed implementation plan and Waters of Life Charter School's attempts at addressing the Board's concerns. Upon resolution of the Board's concerns, the Board determined that, since no conflicts with Section 302A-1182(c), HRS, or Section 302A-1184, HRS, were identified, and the implementation plan would convert to a written contract automatically, it was prudent to move forward in good faith and authorize the charter.

The report identifies three areas related to the approval of Waters of Life Charter School's implementation plan approval that the report indicates were inadequately performed by the Board. The Board, in approving the charter school implementation plans worked closely with the attorney general's office to determine the legal boundaries and limitations of the Board within the charter school law and followed the attorney general's advice.

In the first instance, the report states, "The board's review of the school's governance plans did not adequately scrutinize the school board's membership and how it was to be

governed.” The existing law required the implementation plan to include “A governance structure of the school,” but it did not require nor authorize the Board to review or scrutinize the school’s governance structure, the school board’s membership, or how the school was to be governed.

In the next instance, the report states, “In the case of the Waters of Life Charter School, the board approved its charter notwithstanding an unsound business plan.” The report further states, “The school’s detailed implementation plan, which the board approved and which became its charter contract, illustrates its leader’s lack of business knowledge. The board’s review of the plan was focused on educational issues and ignored basic elements of a viable business plan for the proposed school.” However, Section 302A-1182(c), HRS, requires that the implementation plan include “Annual financial and program audits.” The charter school law does not address a business plan or require the Board to consider the viability of a business plan.

And in the third instance, the report refers to the implementation plan’s facilities management plan and states, “The board’s own evaluators who reviewed the plan voiced strong concern about this issue and recommended against approving the plan.” The report further states, “In its May 2000 detailed implementation plan, the school assured the Board of Education that it had located facilities and begun the permitting and inspection process.” During the review of Waters of Life Charter School’s detailed implementation plan, the Board identified concerns with the school’s plans for facilities. Waters of Life Charter School subsequently submitted assurances to the board regarding the securing of facilities. Upon receipt of the school’s assurances, the Board determined that the school was not in conflict with Section 302A-1182(c), HRS, which states that the implementation plan should include “A facilities management plan that is consistent with the state facilities plan....” In each of the three instances identified in the report, the Board determined that the school was not in conflict with Section 302A-1182(c), and therefore approved the implementation plan.

The report contradicts itself in its accusation that the Board is passive in its role as a charter school authorizer. Despite the law requiring the Board to initiate independent evaluations, the report recognizes that there is a problem with the law, as the report states, “A vague provision requiring the Board of Education to initiate an independent evaluation of each charter school is silent on whether the board may oblige a school to cooperate and pay for the service,” and “There is some uncertainty as to whether the Board of Education can compel the schools to meet their statutory and contractual obligations.” The attorney general had advised the Board that it does not have the authority to initiate an internal evaluation. In fact, the report recognizes the inherent problems when the law does not provide for such authority, as the report states, “Limits on an authorizer’s authority to impose disciplinary or corrective action on noncompliant schools inhibit the authorizer’s ability to address problems or violations.” The report further states that “Section 302A-1186(b), HRS, limits the board’s powers to placing a charter school on probation in cases where student performance standards are not met

or a school is not fiscally responsible.” Consequently, if the Board is unable to require schools to submit to evaluations, how can it determine if the school is fiscally responsible or the school’s performance standards are being met?

In the case of Waters of Life Charter School, the Board was aware that there were concerns regarding the school’s fiscal responsibility and, as such, attempted to initiate an evaluation. The school was notified that staff would be visiting to conduct the review; however, when staff arrived at the school they were not allowed on campus and denied access to the records. The Board consulted with the attorney general to determine its recourse in the matter and was advised to let the matter drop, as the law does not provide for any recourse if a school chooses not to comply.

In further evidence that the Board of Education is not passive in its authorizer role, the Board initiated a lawsuit through the attorney general when it identified that Waters of Life Charter School was in violation of its implementation plan. As a result of the lawsuit, the Board was advised by the attorney general to limit its interactions with Waters of Life Charter School until the lawsuit was resolved.

In further contradiction, the report recognizes that the Board has made numerous requests to obtain annual financial audits and self-evaluation reports from Waters of Life Charter School. The report states, “Repeated requests by the board have gone unanswered.” By repeatedly requesting information, which the school is required by law and its implementation plan to submit, the Board has shown it is not passive in its authorizer function. In addition, the attorney general had advised the Board that it is limited to requesting information from the school and the law does not provide for any recourse if the school refuses to comply. In other words, while the law requires the charter schools to submit various reports, it does not provide the Board the authority to take action against schools for noncompliance. The report holds the Board responsible for areas that the attorney general had advised are outside its legal limits based on the existing law.

The Board believes that the conclusion reached in the report that “The Board of Education’s award of a charter to Waters of Life Charter School without personnel policies and procedures laid the foundation for deficiencies in the school’s management of health and safety issues,” is unfounded and farfetched. The report gives numerous examples of problems experienced by Waters of Life Charter School such as: “...we found that the school board disregarded advice and sound planning practices...;” “Having ignored the county’s advice, the school is now embroiled in a lawsuit with its neighbors...;” “Poor fiscal management has burdened the Waters of Life Charter School from the outset and is still reflected in its substandard accounting practices and passive financial leadership;” and “The Waters of Life Charter School has a history of ill-conceived management processes and lacks the expertise needed to run an effective business operation.” Based on these comments, it is clear that Waters of Life Charter School’s problems were outside of the Board’s control. The Board found itself in the position of dealing with a law that did not provide it with any authority to require

compliance and a school that refused to comply with any laws, as it believed the charter school law provided for an exemption to all laws. The Board does not consider itself passive or responsible for the problems that Waters of Life Charter School have been embroiled in. The Board believes that the existing law leaves the Board little recourse or authority in assuring charter schools are viable and agrees with the reports finding that "Hawaii's faulty charter school law impedes accountability and effective support" and must be clarified.

The Board of Education agrees with most of the auditor's recommendations, especially in that the charter school law needs improvement. This is a high priority for the Board and it will be working with the legislature in efforts to amend the law. Additionally, the Board is working collaboratively with the executive director of the Charter School Administrative Office in its oversight of charter schools, and among other issues, is developing a fiscal probation timeline that address probation and revocation criteria. The Board also agrees with the recommendation that requires charter schools to provide verified and periodically updated listings of fixed assets, but the current law is vague and ambiguous on the Board's authority to enforce compliance.

And finally, an item within the auditor's report needs clarification. The report states, "In addition, charter schools are assessed the cost of these benefits and payroll taxes as a fixed amount per student. Such assessments against student numbers instead of against the size of the payroll result in excessive charges for schools with few staff – in extreme cases, these charges have approached or even exceeded a school's entire payroll." The report does not clearly identify the entity responsible for assessing these charges, and implies that the Department of Education is the responsible entity. In fact, the Board of Education understands that the Department of Budget and Finance is responsible for assessing the charter schools for benefits as a fixed amount per student, and already recognized and corrected the problem in November 2004, and returned the money to the charter schools.

The Board of Education appreciates the efforts of you and your staff and the opportunity to comment on your report.

Sincerely yours,



BREENE HARIMOTO
Chairperson

cc: Board of Education members

LINDA LINGLE
GOVERNOR



PATRICIA HAMAMOTO
SUPERINTENDENT

**STATE OF HAWAII
DEPARTMENT OF EDUCATION**

P.O. BOX 2360
HONOLULU, HAWAII 96804

OFFICE OF THE SUPERINTENDENT

January 12, 2005

The Honorable Marion M. Higa
State Auditor
Office of the Auditor
State of Hawai'i
465 South King Street, Room 500
Honolulu, Hawai'i 96813

RECEIVED
JAN 11 8 00 AM '05
OFFICE OF THE AUDITOR
STATE OF HAWAII

Dear Ms. Higa:

Thank you for this opportunity to comment on this draft report. Your recent audit of Waters of Life Public Charter School is appropriate and timely for the development and success of public charter schools in Hawai'i. Your audit report provides the necessary information and hard data which can be used to develop a statewide system of accountability of charter schools.

The Department of Education would like to clarify the description of the Hawai'i State Assessment noted in the audit report. The following is the most current description.

The Hawai'i State Assessment includes nine sessions for grade 3 and ten sessions for grades 5, 8 and 10. Two of the sessions measure students' achievement in Reading Comprehension and Mathematics Problem Solving based on the Abbreviated form of the Stanford Achievement Test, Ninth Edition (Stanford 9). Students' scores on the Stanford 9 sessions provide a comparison of their performance to that of other children in the same testing conditions.

The Hawai'i State Assessment also includes seven standards-based sessions in reading, writing and mathematics for grade 3 and eight sessions for grades 5, 8 and 10. The assessment results can be used to determine students' progress toward meeting selected Hawai'i Content Standards.

As we look at the proficiency targets, please note that the proficiency targets refer to the **proportion** of the tested students who are proficient in reading and mathematics respectively, not to the scores of any individual student or to the average of those scores for the school. Thus, the discussion about the impact of excluding the scores of a few students in small schools may be out of context.

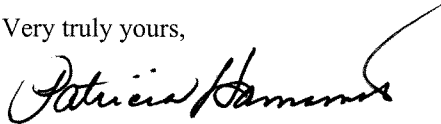
In compliance with the accountability provision of the No Child Left Behind Act, the Department of Education reports on the proportion of students who are proficient in reading and mathematics. Average scores are not used to determine the status of schools under the Act.

The Honorable Marion M. Higa
January 12, 2005
Page 2

Also, there is one item that needs clarification. The audit report states "In addition, charter schools are assessed the cost of these benefits and payroll taxes as a fixed amount per student. Such assessments against student numbers instead of against the size of the payroll result in excessive charges for schools with few staff – in extreme cases, these charges have approached or even exceeded a school's entire payroll." The audit report does not identify the entity responsible for assessing these charges, and implies that the Department of Education is the responsible entity. The Department of Education understands that the Department of Budget and Finance is responsible for assessing the charter schools for fringe benefits costs as a fixed amount per student and has already recognized and corrected this problem by returning monies to the charter schools.

The Department will work with both the State Board of Education and the Charter Schools Administrative Office in support of the recommendations published in your audit report.

Very truly yours,

A handwritten signature in black ink, appearing to read "Patricia Hamamoto", with a long, sweeping flourish extending from the end of the name.

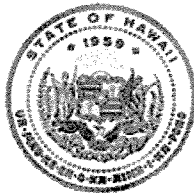
Patricia Hamamoto
Superintendent of Education

PH:CRH:lds

cc: Board of Education
Public Charter Schools Program Office

**STATE OF HAWAII
BOARD OF EDUCATION**

**Jim Shon
CSAO Executive Director**



Charter School Administrative Office

1111 Bishop Street, Suite 516
Honolulu, Hawaii 96813
Tel: 586-3775 Fax: 586-3776
jim.shon@notes.k12.hi.us

RECEIVED

JAN 6 9 46 AM '05

OFFICE OF THE AUDITOR
STATE OF HAWAII

January 3, 2005

MEMO

TO Marion M. Higa, State Auditor
FROM Jim Shon, Executive Director, Charter School Administrative Office
RE Response to *Audit of Na Wai Ola Waters of Life Charter School*
(Draft Received December 30, 2004)

I. General Comments.

The Charter School Administrative Office (CSAO) is in general agreement with this report. Many of the observations and comments by the Auditor are consistent with observations, site visits, and documentation regarding laws and challenges faced by charter schools in general. This audit provided detailed information on the operations of Waters of Life Charter School that CSAO had not yet seen, and is grateful for the extensive work done to generate this data.

This audit should be read within the context of charter school experiences in Hawaii, namely:

- Charter schools have provided a viable educational alternative for many students who have not thrived in DOE public schools. They have done this with significantly less stable and adequate funding. Many of the over 500 employees at charter schools do not enjoy participation in the state's employment retirement system. No DOE public school has had to labor under these conditions. DOE schools have long enjoyed district and state-level support systems for administration as well as curriculum and instruction. For the most part, these have not been available to charter schools.
- In spite of this challenging environment, charter schools have experienced continuous growth, from 3,066 in 2001-2002 to projected enrollments of over 6,000 in 2005. 27% of charter school students attend schools with a special focus on Hawaiian culture, representing a form of educational ethnic safety net for alienated youth in our regular DOE schools. While 70% of charter schools are Title I schools (with a large number of students from poorer families), as a group, in 2004 charter schools outperformed regular public school students in the most recent Hawaii State Assessment and SAT tests. In addition, 40% of charter schools met the SAT honor roll criteria (77% of students in a grade scored at or above the national norm on *both* reading and math.)

This response will cover the following: actions taken independently of this Audit which relate directly to its comments and recommendations, specific comments on the recommendations, and specific comments on selected elements of the audit.

II. Recent Relevant Actions Taken

A. Charter School Conference Initiatives

Following discussions and agreements reached at a recent Charter School Conference on December 4, 2004, co-sponsored by the CSAO and the Hawaii Charter School Network, the CSAO initiated the following, which relate directly to Audit comments and recommendations. Several working groups were created, namely:

- a. *The Charter School Ad Hoc Working Group on Accountability* charged with developing draft fiscal and academic accountability guidelines for consideration by the Board of Education. This group will also consider criteria and processes for the four-year charter review.
- b. *The CSAO Financial Accounting Systems Group*, headed by the CSAO's Chief Financial Officer. This group will determine a common accounting system for all charter schools that can be reviewed by CSAO and allow for financial data on each school to be posted on the web, recommend an alternative to utilizing the DOE's internal accounting, payroll and personnel systems, and set out the criteria for annual audits.
- c. *The CSAO Special Education Task Force* that will monitor charter school SPED operations, facilitate regular multi-school SPED meetings, and assist each school in meeting the needs of its SPED students;
- d. *The Charter School Technology Team* that will utilize the Internet to connect all schools, interface with the needs of the Financial Accounting Systems Group, and allow for the exchange of important business, governance, and educational strategies and experiences.
- e. *The Curriculum and Research Support Committee* will document best practices in curriculum, conduct research on the effectiveness of innovative educational strategies, and assist individual schools in improving their academic assessments and achievements.
- f. *The Higher Education Consortium* will ensure that charter school teachers and staff have a seamless and affordable system designed to create a highly qualified teaching pool that meets or exceed NCLB requirements.

B. Title II Professional Development Plan

Speaking to the issue of academic achievement and support, the CSAO has recently developed a plan for the use of federal Title II funds that will achieve the following:

- a. Provide each school with qualified Special Education staff, including an SSC, certified SPED teacher and EA.
- b. Upgrade charter school math teaching & student achievement.
- c. Provide resources to initiate or continue curriculum related teacher training; and
- d. Ensure that each school has ongoing educational research conducted by its teaching staff.

C. Proposed Changes to the Charter School Laws

As a result of discussions with the 27 charter schools, a number of amendments to the existing charter school laws will be introduced for consideration in the 2005 Legislative Session. These include:

- a. update the funding formula to ensure that the most recent legislative appropriation for public education forms the basis for calculating the per pupil allocation to charter schools – thus ensuring greater fairness, adequacy and stability in funding;
- b. appropriate funds to offset the costs of facilities for charter schools and qualify for matching federal facilities funds;
- c. ensure that fringe benefits are not deducted as a percentage of the entire charter school operating budget;

- d. guarantee basic public employee rights, namely that all charter school employees will be attached to a State self-insured workers compensation pool;
- e. create a more rigorous standard for the chartering of new schools;
- f. allow qualified personnel to move more freely between the department of education schools and charter schools;
- g. authorize the CSAO Executive Director to issue binding policies and guidelines for the operation and management of charter schools – it is unclear what authority CSAO would have to impose corrections or sanctions on any specific charter school;
- h. enable the charter schools to propose their own weighted student formula;
- i. prohibit employees of a charter school from serving as officers on the Local School Board, and requiring the LSB to adopt conflict of interest policies.

III. Comments on Recommendations in the Audit (pp. 35-37)

Recommendation No. 1: Convening of an Expert Panel To Review the Laws

There have been extensive discussions regarding the charter school laws throughout the charter school community. The above list of proposed charter law amendments is reflective of these discussions. The recent establishment of a fully staffed CSAO represents a new and potentially significant institutional actor in the administration of charter laws. Some of the issues raised by the audit, such as employees without retirement or health benefits, are being resolved through discussions and negotiations with the ERS and EUTF administrators by CSAO. While it remains to be seen how many of the ambiguities and challenges can be resolved without statutory change, it is important to recognize that one of the most persistent problems for charters have been continuous changes in the laws under which they are governed, and the need to expend significant time and funds on the part of charter school administrators over disputed interpretations of each new law. *In short, there is a financial and personal cost associated with each major change.*

It may be wise to adopt an incremental and administrative approach, one which empowers the CSAO to pursue negotiated solutions and to document how far this strategy can go in resolving issues. However, the convening of a multi-stakeholder group to review not only the laws but also the role and future needs of the CSAO would be helpful. CSAO would be pleased to convene such a group and report back to the 2006 legislative session. The following are specific comments on items suggested for review:

- a. Powers, authority and requirements of schools, local school boards, etc. Initial elements of this will be addressed by our *Charter School Ad Hoc Working Group on Accountability*, as well as legislative discussions relating to greater empowerment of the CSAO office.
- b. Application and start-up process... The application for conversion of DOE schools to charter school status includes extensive documentation of a school's plans, including the development of a financial plan using the last per pupil allocation. Whether or not the data in such an application is verified, is another matter.
- c. Charter school exemptions from laws... CSAO was recently asked to review a list of such laws, many of which reference internal DOE policies and practices, rather than generically apply to independent charter schools. While on its face a law may appear appropriate, to simply reference the law as applying to charter schools may create significant entanglements and unanticipated consequences. This is the result of a legal history in which the DOE was synonymous with all public schools. Because charter schools are not DOE schools, efforts will need to be made to incorporate the essence of certain laws without the DOE involvement.

- d. Real property and business liabilities...CSAO agrees that this is an area that needs analysis and attention.
 - e. Conflict of interest in CSAO Office. CSAO was created in part because charter schools sought a more neutral source of oversight. If CSAO is empowered to create oversight and support policies, it may be easier to better define the role of the BOE. As of this date, I have not found this inherent conflict to be an issue, however, this is in part a result of the collaborative and “hands off” flexibility provided by the current members of the BOE. Future members may, however, have a much different view, one in which the conflict could again become a problem.
 - f. State benefits for charter school employees. CSAO hopes to resolve some of these issues through proposed changes in the law during the 2005 legislative session, as well as negotiations with unions. However, CSAO would welcome any expression of legislative intent that a “second class” of public employees not be created through the treatment of charter school employees.
 - g. Assistance with facilities needs. CSAO fully endorses this item, including “priority access to any vacant government buildings suitable for conversion to a school.”
2. Recommendation No. 2. Recommendations to the Board of Education.
It is clear that until the creation of the CSAO, the BOE had no appropriate agency to work on strategies, rules and regulations relating to oversight. The DOE’s Public Charter School Office administrates federal grants and serves as a surrogate DOE personnel office for schools that purchase these services and clearly lacks the authority or mission of the CSAO. By the end of the 2004-2005 fiscal year CSAO will provide the BOE proposed policies and guidelines for adoption and serve as its administrative arm in implementation of such measures.
 3. Recommendation No. 3. BOE/CSAO support for exchange of problem solving strategies.
As noted in the above narrative, CSAO is already moving aggressively in this area.
 4. Recommendation No. 4: Waters of Life Charter School. All of these items are excellent guidelines for all charter schools. It is our hope that CSAO will be able to create systems and policies that meet this six point standard for all charter schools.

IV. Specific Comments on the Audit

1. P. 11 Employee benefits, entitlements and assessments remain unresolved.
CSAO strongly endorses this analysis. No State agency appears to have the responsibility for ensuring that charter school employees have full benefits.
P.12 The State may become liable for mortgages on real property. Without funding for charter school facilities, it is likely that real property issues will grow in importance.
2. P. 12 For-profit ventures may raise revenues but also create unintended legal entanglements. This is an area that certainly needs attention. While the growth of for-profit ventures could significantly supplement charter school revenues, without clear guidelines there may be many problems.
3. P.12 Facilities funding issues have not been resolved. This is a high priority for charter schools.
4. Pp 13-21. Board of Education issues. CSAO did not exist when many of these issues arose. I cannot comment on the experience of previous Executive Directors. However, since assuming this position, it has been clear that the BOE is committed to ensure that CSAO moves quickly to address many of these issues. They have provided encouragement and unanimously approved the CSAO proposed charter school budget

request (except for facilities funding). The BOE recently created a separate committee for charter schools. The growing partnership between BOE and CSAO may be the answer to many of the criticisms raised by the Auditor in this section.

5. Pp. 21-34 Specific Criticisms of Waters of Life. CSAO is unable to comment on much of this section as the Auditor has provided specific information on the internal operations of a school that CSAO had not yet had access to or reviewed. Persistent issues relating to all charter schools are governance, management, and poor or non-existent record keeping. The period of benign neglect in which Waters of Life or any other charter school could operate with little or no oversight or professional support is coming to an end. By this time next year I believe it will be inconceivable that the alleged failures cited in the Audit would have go unnoticed or uncorrected.

The Auditor did make an important comment worth noting:

Waters of Life Charter School's steady enrollment between 130 and 160 students in the last three years, up from 76 in school year 2001-02, is an indication that the school is with its students and being well-intentioned, hard-working, and dedicated. We heard anecdotal account of children doing well at Waters of Life Charter School after being in danger of failing at a traditional public school. (p. 21)

CSAO suggests that the shortcomings of administration and governance do not negate the educational accomplishments of charter schools. In fact, it is somewhat surprising how many schools have provided a viable educational alternative *without* having professional support systems.

As this audit goes to press, the Department of Education is busy preparing training programs for DOE principals who will have new roles and responsibilities under Act 51, including managing a weighted student formula funding system. It is fair to say that the duties of a charter school director often exceed the duties of a DOE principal under the new law, yet the state has taken no action to provide training for charter school board members or administrative leaders in the past, and has provided no earmarked funding to assist charter schools in the future.

While the possible shortcomings of past Waters of Life Charter School administrators may well be centered in lack of personal administrative professional skills, it is obvious that they operated in a system that accepted little or no responsibility to provide support.

RESPONSE TO Audit of Na Wai Ola Waters of Life Charter School



Nā wAI OLA 'Waters of Life' Public Charter School
P O Box 1012, Kurtistown, HI 96778 Ph 808-968-1275 Fax 968-8011
Email: waiolapcs@hawaii.rr.com, Katheryn Crayton-Shay, Administrator

January 6, 2005

Marion M. Higa, State Auditor
State of Hawaii
Office of the Auditor
465 S. King St., Room 500
Honolulu, HI 96813-2917

RECEIVED

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OFF. OF THE AUDITOR
STATE OF HAWAII

Dear Marion Higa:

We have reviewed the draft report of *Audit of Na Wai Ola Waters of Life Charter School*. Along with the Local School Board Chair, Mr. Paul Wheelless, and the school's administrative team, I have prepared a response and request that you include our response in the final draft before submitting the completed document to the Board of Education, Department of Education, Charter Schools Administrative Office, Governor, and presiding officers of the two houses of the Legislature.

I am available to respond to any questions regarding this document.

Sincerely,


Katheryn Crayton-Shay, Administrator

Enclosures

Na Wai Ola “Waters of Life” PCS
Local School Board

Paul A. Wheelless
Board Chair

Yvonne Hartzell
Board Vice Chair

Jodi Aryioshi
Board Treasure

Julie Remington
Board Secretary

January 5, 2005

Marion M. Higa
State of Hawaii
Office of the auditor

Ms. Higa:

I did receive copy number 24 of the confidential draft report for the audit done on Waters of Life PCS, and found it to be a very good read for the history and the seemingly overwhelming problems at hand. But I do not see it that way. I see this as public statement to all that are concerned about this school becoming a grade A, top of the line alternative institute of education.

The report indicates that there are three entities involved with the successful operation of this school. I can only speak to one of those entities, Waters of Life PCS. I was not taken by surprise while reading this report. As a parent of a high school student in the school, I found problems that concerned me greatly. So I joined the Local School Board with the mission to change the weaknesses in policies into strong, productive, fair policies.

As the new chair of the Waters of Life Local School board, I have instructed the director and school staff to “clean up the old mess” as quickly and fairly as possible. I am working along side the director to ensure that appropriate guidance is present. Old debts will be paid and any past warranted and/or unwarranted litigations that are blocking the school from accomplishing the business of providing the youth in our area with the best education in the state will be dealt with in a “win-win” manner.

I have also instructed the school’s director to make available to me and to the board all policies and procedures so they can be reviewed then changed, modified, rewritten, or discarded. I would expect nothing less from the State Legislature or the Board of Education. We are only as good as and the rules and policies that govern us.

In the report I did see that the farm business was purchased by the school, however, after my investigations, I discovered this is not true. The old Sunshine Farms land was

RESPONSE TO Audit of Na Wai Ola Waters of Life Charter School

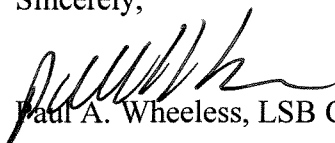
purchased by the school. A teacher and his wife took ownership of the plant business in an attempt to integrate it into the school as an agri-business that would assist in funding the school. As the farm business stands today, it is completely separate from the school with new outside ownership.

As the New Board Chair, I held my first board meeting in December of 2004. During this meeting I stated to the board that old practices would not continue. The board is the governing arm of the school and we will work with the school in a professional and ethical manner. I do agree that a high level of board membership is needed. One of my goals as chair is to actively teach the board its responsibilities and how to govern.

When I was in the United States Army as a medic I was charged with the responsibility of all the Battalions' medical supplies. I had to create a supply system that would re-fit and re-supply the battalions in peacetime and during combat. The Inspector General Corp. would conduct yearly inspections of all the battalions. I looked forward to the Inspectors lists of failures in the system so I could fix them. After, two years of confrontation with the IG Corp., I was reassigned to the IG Corp the next year, only because the Army Inspector General said. "I have never seen a sergeant in today's Army with as much "can do" attitude as you. Your tenacity and ability to get the job done is a great reflection on the United States Army."

In conclusion, I will be available to meet with other Charter schools on this Island, the Charter School Administrative Office, and the Board of Education to correct any flaws in the Hawaii Charter School System in a timely manner. I view this report as a tool to better the Charter School System in this State and look forward to the challenge.

Sincerely,



Paul A. Wheelless, LSB Chair

RESPONSE TO Audit of Na Wai Ola Waters of Life Charter School

Attention Auditing Personnel:

Our response to the audit is three-pronged. In Section A “Response to Recommendations“, we have addressed the six recommendations in the summary. Our responses are ‘categorized’ and have been logged by page numbers of the audit that correspond to the individual recommendation. In Section B we tackle the issue of creating financial viability and solvency for the school. Section C “Secondary Revisions”, requests that changes be made in your presentation of two facets of our school’s operations. Throughout the response report, we ask that you give particular attention to all underlined items and request that you revise the final document accordingly.

Summary of Findings reveal that:

Waters of Life Public Charter School’s disregard for sound governance and business practices has placed its continued viability at risk

Waters of Life’s fiscal problems are rooted in the board’s approval of a defective detailed implementation plan.

A. Response to Recommendations

Waters of Life Charter School should:

1. *Ensure that hiring practices comply with its detailed implementation plan, prudent personnel practices, and all safety and health related requirements*

a. Re: Teacher Qualifications (Pp18-19)

Of the nine teachers working in June 2004 as FTE at WOLPCS, three (not two) held Hawaii state teaching licenses . Of the remaining six, two were then and currently are enrolled in Teacher Preparation Programs and have prior teaching experience; one has a Masters degree in Education, more than 2 years teaching experience, and was seeking certification through the NBPTS; one was finalizing the requirements of the Minnesota TPP by completing the Praxis tests; one holds a Masters degree in Education and has more than 2 years teaching experience; one hold’s a Bachelor’s degree, had no prior teaching experience, and had taken the initial Praxis exams to enter a TPP . This updated information reveals that 8 of the 9 teachers were in compliance with the school’s charter for teacher requirements at the time of the review. Further, each teacher is required to submit verification to the DOE and to the Public Charter School Office in order to secure a contract; salary is determined by information provided in these documents.

b. Re: Personnel Records (P 19)

All WOLPCS staff members have been fingerprinted; the results of the fingerprinting is made available to the school only if the employee is a convicted felon or has criminal history. Our records show completed fingerprinting applications only. Clarification about obtaining tests results is needed from Public Charter School Office.

c. Re: Bus Drivers (P 20)

The previous breach of security procedures around securing safe, competent drivers has been remedied. Only one of the previous 7 drivers hired by WOLPCS currently transports our students. This individual has been retained as our transportation coordinator. He now follows Dept of Transportation guidelines and maintains traffic abstracts, criminal history checks, drug tests (both initial and random), and

RESPONSE TO Audit of Na Wai Ola Waters of Life Charter School

driver training records on the drivers he supervises. He adheres to the school's hiring policies and participates on the Interview team.

d. Re: Hiring Procedures (Pp 20-21)

Our Interview team does reference checks on potential employees upon completion of the interview, however, phone calls were documented in the personal phone logs of interview team members or on post-its attached to interview ranking sheets or resumes. We have implemented the practice of documenting reference checks for all potential employees and securing the findings with the SASA.

2. *Constitute and operate its local school board in a manner consistent with recommended practices and ensure that new school board members receive appropriate training*

a. Re: LSB's Development into an effective Governing Body (Pp 22-23)

LSB Training with local, independent board trainer starts at the beginning of second semester. The chair has scheduled monthly training sessions for the duration of the school year.

b. Re: LSB's Lack of Experience and Diversity (Pp 24-25)

A point of reference, in Hawaii, charter schools have been encouraged to include parents and employees on their local school boards.

From its initial inception, efforts have been made to strengthen the LSB with community members adept in business, financial management, and legal skills. Media exposure of WOLPCS's challenges, which started in the beginning of the school's second year and has not ceased, has not helped us garner additional community members to help strengthen the board.

This year we have revisited the board's configuration. Until we can build a LSB of which the majority of members are professionals who reflect various levels of expertise needed to ensure sound governance and appropriate fiscal management, we have made modifications that will accommodate change. The total number of board members has been increased to thirteen; the number of employees has been reduced to three (not including the director). The community-at-large positions, presently set at two, will gradually increase to a majority of board positions as the board attracts competent professionals to build needed diversity.

So that all members are aware of each meeting's focus, agendas for monthly meetings are forwarded in advance to members giving each ample time to peruse; agenda items may be modified prior to meeting date by contacting the secretary or board chair.

c. Re: LSB's Hiring Decisions/Formalization (P 27)

WOLPCS's hiring procedures are delegated to the Interview team which is comprised of the lead teacher, counselor, Student Services Coordinator, Director, and one board representative. After a thorough interview process, the interview team submits its recommendations for approval to the LSB. Budget projections are revisited to include the potential new hire and reference checks are confirmed. The board officially motions to accept the recommendations of the interview team. All personnel procedures are handled by the SASA who is monitored by the director.

The board chair, SASA, and director will review all employee contracts; where job

RESPONSE TO Audit of Na Wai Ola Waters of Life Charter School

descriptions and contracts have been nebulous or non-existent, modifications of standardized descriptions will be constructed and contracts will be written, reviewed with employees, signed, and filed with SASA and payroll accountant.

3. Acquire competent business staff, capable of establishing and maintaining financial records in accordance with generally acceptable accounting principles and contract for an independent financial audit to establish its fiscal status and viability

a. Re: Fiscal /Financial Guidance (P 14)

We have recently hired a SASA competent in accounting management procedures who will be groomed by the current CSAO's Chief Finance Officer.

The new SASA has been previously employed in several businesses that were in dire financial straights or were not compliant with State and Federal tax laws. The first thing that she did was to get current, i.e., pay any taxes and/or Accounts Payable currently due, and then work on paying any prior debt. This course of action has been put in place at WOLPCS.

With regard to previous SASA/Business Managers-please note that the former Business Mgr, hired in 2002-2003, had a MA in Accounting and operated a successful Income Tax Preparation Business

The former Local School Board Chair from 2001-2003 was a licensed, practicing accountant. She worked with the SASA and director to ensure proper bookkeeping practices were in place for the school.

b. Re: Stewardship of Funds (P 21)

It is the goal of WOLPCS to rise to the expected level of accountability expected of a public entity by putting in place sound governance and financial management practices. By requiring prior approval of purchase orders by LSB or administrator approval, maintaining proper inventories, and correctly identifying funding sources for revenues and expenditures, we will improve our fiscal accountability. The entries for the Ala Loop property are being reviewed and are correctly recording the value of that asset. We accept the obligation to properly account for our public resources by applying them efficiently, economically and legally. It is just as important that WOLPCS pay attention to the efficient and proper conducting of business matters as to the education of our children. To this end the new and current administration and local school board have dedicated themselves.

4. Adopt written policies and procedures for accounting, personnel, and a procurement process consistent with the goals of public accountability and prudent procurement practices

a. Re: Defective Financial Reports (Pp 29-30)

The new SASA came on board October 11, 2004, filling the position which had been vacant since August 31, 2004. She does have a BS Degree in Business Management with Specializations in Accounting and Personnel Management. Within the first few weeks of employment she began to notice entries in QuickBooks which she questioned as to proper accounting. Upon further review, she began to make journal entries to correct the Employees Accounts Receivable in the current year. Working with an independent accounting consultant, both are continuing to review, identify and make correcting journal

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entries to properly reflect correct accounting procedures. Of special interest were the “net” entries for payroll checks and revenue items. The SASA is in the process of correcting these entries to properly record wage and P/R tax expenses for the current accounting year. The revenue items are also being reviewed and corrected to reflect gross revenue and associated expenditures. As part of this process, the chart of accounts is being reviewed to clarify and simplify it. Accounts are being inactivated where possible. Use of overly specific accounts is being eliminated.

Revision is being done of all financial entries made in QuickBooks since 2000. The process to correct entries in QuickBooks to proper accounting has begun. Journal entries to correct the Employees Accounts Receivable in the current year have been done. The SASA, working with our accounting consultant, are continuing to review, identify and make correcting journal entries to properly reflect correct accounting procedures. Of special interest were the “net” entries for payroll checks and revenue and expenditure items. The SASA is in the process of correcting these entries to properly record wage and P/R tax expenses for the current accounting year. The revenue items are also being reviewed and corrected to reflect gross revenue and associated expenditures. As part of this process, the chart of accounts is being reviewed to clarify and simplify it. Accounts are being inactivated where possible. Use of overly specific accounts is being eliminated.

Procedures for collecting payroll advances are being put into place.

1) Having employees sign an agreement for repayment of advances was begun by the Administrator and 2) the SASA would like to consider possible payroll deduction plans to cover amounts due.

The new SASA is being paid at the appropriate range for a SASA.

b. Re: Accounting Procedures/Qualified Financial Administration (Pp29-30)
The Chief Financial Officer of CSAO will begin the personal financial grooming of SASA, Director, LSB Chair/Treasurer.

The administrative personnel have undertaken the reorganization of office files. The A/P records are now in alpha order by vendor. Other school records have been and are being reorganized. Inventory of WOL assets is being organized and asset listings will be created. Research is being done by the SASA regarding prior purchases of assets and verifying against original documentation to substantiate recorded value.

There has been some delegation of accounting duties. Expenditures, reimbursements, and purchase orders must be authorized by the Administrator and/or the Local School Board. Student attendance and lunch count reimbursements are being done by the Office Clerk. Payroll processing is also being done by the SASA or Office Clerk. The independent contractor has subsequently been put on a regular employee status with benefits.

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c. Re: Financial Mismanagement (Pg 31-34)
It is unacceptable for check amounts not to match supporting documentation. This has ceased as of October 11, 2004. In order for payments to be made for supplies and equipment, the proper approvals must be signed off, invoices received from the vendor and correct payment be made in a timely manner. Payment of wages is and has been handled directly by the DOE. For WOLPCS staff wages are outsourced through Taketa, Iwata and Hara & Associates, CPAs. We report the hours/salaries to be paid; they do the calculation and check preparation. They also file and deposit the taxes electronically that are due to the State and Federal governments. With each entity any changes to employee information must be documented with proper approvals where appropriate and forms filled out and submitted to the paying agency.

WOLPCS will consider utilizing the QuickBooks Audit Trail to maintain a record of all

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accounting entries and changes.

5. *Budget for competent professional advice in legal and financial matters when in-house expertise is inadequate*

Before the LSB adapts scenarios for solutions related to challenges the school faces regarding legal or financial issues, WOLPCS will continue to consult attorneys, land use commission advisors, real estate appraisers, county building code specialists, engineers, or architects for advice. Where appropriate, the LSB chair and the school's director will do research online. Application for grants and other fund raising events to provide further funding is being pursued. Sale of school real estate is also being considered as a measure for gaining revenues to meet anticipated expenses.

To ensure the integrity of data entry into the accounting system WOLPCS will appeal to CSAO's Chief Financial Officer for a strategy to segregate accounting duties to minimize management control weaknesses.

6. *Ensure that independent contractors are not improperly classified as employees, seeking guidelines from the Internal Revenue Service if necessary*

The independent contractor has subsequently been put on a regular employee status with benefits.

B. Creating Solvency/Financial Viability for WOLPCS

The official conclusions of the audit mandate that sweeping changes be made in the governance and financial management of WOLPCS to ensure its viability.

We are developing plans to meet the school's financial commitments and obligations.

The LSB has reviewed the current assets of the school. As we seek the advice of financial management specialists, we have considered the following options:

1. We have considered selling the Ala Loop Property and/or the Hawaiian Acres property at 8 Rd . This will require an appraisal of both sites. Any sale of the properties (based on present market value) must deliver the school from mortgage payments as well as pay off all financial obligations and allow for financing the construction of facilities at the remaining or alternate site. Informal evaluations will allow us to assess the market value of both the properties we own and the properties we might lease. Any lease agreement would include provisions for options to buy.

The Ala Loop Property was purchased to provide a site to educate our students; as of this writing we have not been able to achieve that goal. The LSB and directors have initiated past discussions about selling the properties we own, however, division around this issue has stagnated our seeking professional guidance about the feasibility of such a move.

a. Farm Business /Use of school funds (P 26)

The original intention of sale was to sell the only land to the school. The business was a gift to the school, that was included to help pay off the mortgage; the business was never officially purchased. The school was not able to manage this gift and advertised for managers . When no one responded, the _____ volunteered to relieve the school of the responsibility until time came when the school would assume responsibility of the business. This 'gift' has been separate from school since that time. Equipment was bought for the school with farm revenues as compensation for rent and use of facilities and

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utilities. At no time did school funds pay for farm salaries, supplies, equipment.

2. Paradise Park Hui has set aside acreage for schools. We are currently investigating the possibility of liquidating our assets to finance a complete move of the school to that area. A formal proposal of our plans must be submitted for review by the Hui's board. Special land use permit codes would probably apply. A site evaluation done by private contractor on behalf of school is required.

Contacts with realtors and others in the Puna area have revealed that availability of facilities for sale or lease is scant, particularly when the factor of zoning restrictions is applied. While prospects seem low, every referral is researched and investigated.

3. Research is being done by our Resource Development Chair to determine the financial feasibility of growing hydro-ponic crops. In this marketing venture, WOLPCS would grow, harvest and provide produce for local restaurants and cafeterias. The 'Farm to Cafeteria' project has been designed to create business development opportunities for farm schools. Establishment of 501C3 status for the school to enhance grant eligibility is underway for this and other related ventures. A complimentary short-term marketing venture involves WOLPCS selling the varied types of palm trees growing on the Ala Loop property to hotels/resorts, home owners, land developers, gardeners, planners, construction agencies. We have categorized many plants (with the support of the former owner) and have been given market value quotes for some trees.

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C. Secondary Revisions

We ask that you incorporate these revisions in the final draft to present a more accurate reflection of the school's operations related to testing and facilities:

1. RE: Quality of Education/Testing (P 17)

WOLPCS submitted documentation to confirm numbers of Grade 10 students tested during 2003. All students who were still enrolled during the Spring Semester were tested unless they were repeating 9th graders. The enrollment numbers reviewed by the auditors reflect entrance numbers; these numbers do not accurately reflect student exits or transfers.

2. Re: Testing Integrity (P 18)

The DOE requires all test coordinators to attend yearly district training sessions. WOLPCS test coordinators and administrators have attended all sessions in the past years. Test proctors are trained by the coordinators before tests are administered. WOLPCS's coordinators arrange the testing schedules, maintain accurate daily records of students tested in each session, set up testing sites, secure testing materials daily, and schedule test make-up sessions. Coordinators provide assistance to proctors in the classroom to maintain integrity. Let the records show there has never been a suspicion, hint, documentation, complaint, or report of any incidence of testing impropriety of the Hawaii Content and Performance Standards test within the past four years at WOLPCS. (The slightest suggestion of such is unduly damaging to this aspect of the school's operations and should be stricken from the report, particularly because, by your own statement, auditors were not able to review the testing process and have no information on WOLPCS's administration of the tests.)

3. Re: School's Move during 2000 (P 23)

The school was not forced to relocate to another facility in mid-year. All school sites continued operations until the end of the 2000-01 school year.